

**SUBMISSION TO THE SENATE ECONOMICS COMMITTEE**

**COMPETITION WITHIN THE AUSTRALIAN BANKING SECTOR**

1. This submission concentrates on one of the terms of reference - reference (l), on ‘the role and impact of past inquiries into the banking sector in promoting reform’.

2. Given the tight deadline for submissions and the severe constraints on my time at this time of the year the submission is necessarily brief. I would, however, be happy to meet with the Committee to discuss matters raised in the submission and any other issues relating to the inquiry’s terms of reference.

3. In Australia during the twentieth century there were five public inquiries conducted into aspects of the Australian monetary, banking and financial systems, one of them being a parliamentary inquiry. Each of the inquiries is discussed in my commissioned work for the Reserve Bank of Australia entitled *The Evolution of Central Banking in Australia*, published in January 2010 to mark the fiftieth anniversary of the Reserve Bank.

4. The five inquiries were:

- The Royal Commission Appointed to Inquire into the Monetary and Banking Systems of Australia (1935-37)
- The Committee of Inquiry into the Australian Financial System (The Campbell Committee) (1979-1981)
- The Committee to Review the Australian Financial System (The Vic Martin Committee) (1983-1984)
- The House of Representatives Standing Committee on Finance and Public Administration Inquiry into Banking and Deregulation (The Stephen Martin Committee) (1990-1991)
- The Financial System Inquiry (The Wallis Committee) (1996/1997)

5. While each of the inquiries had its own particular genesis and impact, there were nonetheless some common elements connecting them. The Royal Commission of the 1930s was an outcome of the Great Depression and the concern among individuals and groups at the time that the banking system - including the central bank (then the Commonwealth Bank) - had played a significant role both in initiating the depression and prolonging the process of recovery. The government of the day, led by Joseph Lyons, lost its outright majority at the 1935 general election and was compelled to form a coalition government with the Country Party. The Labor and the Country Parties had gone into the election promising an inquiry into the banking and monetary systems. Though originally opposed to the idea of such an inquiry, Lyons finally agreed to a Royal Commission, which was established soon after the new government was formed; it reported to the government in 1937.

6. The establishment of the Campbell Committee followed promises made by the Prime Minister, Malcolm Fraser, at the 1975 and 1977 elections that a Coalition government would create, if elected, an inquiry into the operation of capital markets in Australia. Following the 1975 election the government failed to establish the inquiry, but it repeated the promise at the 1977 polls. Early in 1978 the idea of an inquiry into capital markets was substantially widened to embrace the financial system as a whole, including the Reserve Bank's legislation and its operations. The Campbell Committee reported towards the end of 1981, having been formally established at the beginning of 1979.

7. The (Vic) Martin Committee was commissioned by the Hawke government soon after it came to office in 1983. Its terms of reference were, in effect, to review aspects of the Campbell Committee's recommendations in the light of the new government's economic and social priorities. It reported to the government early in 1984.

8. The House of Representatives Standing Committee on Finance and Public Administration set up the (Stephen) Martin Committee in late 1990 to assess the results of deregulation following the implementation of the Campbell Committee's recommendations. At the time there was considerable public concern that financial deregulation may have contributed in some measure to the recession and financial collapses of the early 1990s. The Stephen Martin Committee reported to the parliament in 1991.

9. The Wallis Committee was created soon after the Howard government came to office in 1996. The Coalition parties had made it clear in opposition that, in the event of being returned to government, they would establish an inquiry to examine the consequences of financial deregulation in the Australian financial system since the early 1980s. The inquiry was also asked to analyze possible forces that might contribute to further changes in the financial system, especially those that could arise from the advent of new technology.

10. In the years since the Wallis Committee reported in 1997 numerous calls have been made for another major inquiry into the Australian financial system along the lines of the Campbell and Wallis inquiries. It has been said that the Campbell Committee recommended that such inquiries should occur every 10 years, as appears to be the present practice in Canada and perhaps in some other countries. Whether individual members of the Campbell Committee had recommended that regular independent reviews of the financial system should be conducted in Australia is not entirely clear, though it appears that no formal recommendation along these lines was made by the Campbell Committee itself. However, in its report, the Stephen Martin Committee claimed that the Campbell Committee had recommended that a regular decennial review of the financial system should be undertaken for the purpose of 'monitoring changes, obtaining the views of participants and making appropriate policy recommendations.' (Stephen Martin Committee Report, p. 29). What the Campbell Committee did recommend was that the Reserve Bank should 'undertake a *continuing review* of the structure, regulation and operation of the *financial system* with the object of, from time to time, canvassing options for change.' (Campbell Committee Final Report, p. 28-9)

11. Financial systems and institutions never stand still but are always evolving. New institutions arise and old ones decline; new financial instruments are developed and old ones

disappear; and new technologies create scope for different structures, processes and methods of operation. Often regulatory procedures and practices operated by the monetary authorities lag behind developments occurring in the market place. These lags can lead to problems and sometimes financial and banking crises occur as a result. Inquiries are frequently established in the wake of financial crises for the purpose of examining the origins of the crisis, their consequences, and how they might be avoided in the future; recommendations for change are usually advocated in the reports of these inquiries, and the recommendations are often adopted. As the Wallis Committee commented in its report: 'Change in the financial system implies the need to adapt regulations imposed on financial institutions and markets. Regulation must adapt both to facilitate greater competition and efficiency in the financial sector and to secure the integrity and stability of its operations.' (Wallis Committee Final Report, p. 1)

12. Previous inquiries into the Australian monetary, banking and financial systems resulted generally from major economic and financial crises. For example, the Royal Commission of the 1930s arose directly from the Great Depression in the early years of that decade. The Campbell and Martin inquiries arose from disquiet arising from the Great Inflation of the 1970s and early 1980s, while the Stephen Martin and Wallis inquiries followed the recession of the early 1990s and the associated financial collapses and near collapses at that time. Given the circumstances that promoted earlier inquiries, it is not surprising that, following the Global Financial Crisis or Great Recession of 2007/09, calls have been made for a new inquiry; similar calls for inquiries have been made in other countries. New methods and techniques of operation in the financial services industry were introduced over the preceding twenty years and some of them contributed no doubt to the recent financial and economic collapses around the world. The financial crisis itself has revealed weaknesses in regulatory procedures in some of the world's preeminent financial centres, and there have been deficiencies in the way that some of these countries have conducted their monetary and financial policies.

13. Ideas about banking and financial regulatory frameworks have a tendency to advance in cycles. This phenomenon was highlighted in the report of the Stephen Martin Committee. There it was remarked that the ebb and flow of regulation and deregulation had tended to develop in a cyclical form. Regulation and deregulation, it concluded, 'has moved in a cycle. A lack of regulation contributed to some banks and NBFIs [non bank financial institutions] collapsing in the 1890s. This led to tight regulation being imposed on banks. As a result, NBFIs were able to grow more rapidly and became more prone to problems than the banks. Recently regulations on banks have been eased and those on NBFIs are in the process of being tightened.' (Stephen Martin Committee Report, p. 35) The formation of cycles usually comes about as a reaction to previous regulatory frameworks: the lack of regulation is blamed for creating a crisis and the system is consequently regulated. Then another crisis occurs; it is attributed to over-regulation and the system is deregulated. Deregulation is then blamed for the next crisis and in due course new regulations are imposed. So the circle is joined and a new one about to commence.

14. The Royal Commission in the 1930s recommended stricter controls – both of a direct and indirect nature – over the monetary and banking systems of Australia; many of them, supplemented by further controls, were introduced during the war years. By the 1960s, however, it had become clear that controls imposed on the banking system were making it

difficult for the authorities to conduct successful monetary policies and had created inefficiencies and distortions in the financial sector. Consequently, calls were made for deregulating the system. These calls for reform then grew louder with the arrival of severe economic difficulties in the 1970s and early 1980s associated with stagflation and led to the creation of the Campbell Committee in 1979 and the related (Vic) Martin Committee in 1983. Concern in some quarters about possible links between deregulation and the economic recession and the financial collapses in the early 1990s led to the setting up of the (Stephen) Martin Committee. Although the Wallis Committee, established in 1996, was not the direct result of problems considered by some to be the result of deregulation, its origins can be traced in some measure to difficulties linked to the financial problems experienced in the early 1990s and the related debate on whether the central bank or another body should have responsibility for the prudential oversight of individual financial institutions.

15. Pursuing the major themes of the inquiries somewhat further, the Royal Commission sought to elevate the power of the central bank and diminish the influence of the private trading banks. Its preferred approach to monetary policy was for the Commonwealth Bank to use its commercial banking functions to influence bank interest rates and credit policy generally and to secure the cooperation of the private banks for the policies it wished to pursue. It recommended that the private banks should operate under license, which could be withdrawn if they failed to conform to government policy. It further recommended that the banks should lodge a certain proportion of their deposit liabilities with the central bank, preferably on a cooperative basis, but by compulsion if need be; this would serve at once as a financial stability device and an instrument of monetary policy. The Royal Commission, contrary to received opinion, did not recommend controls on bank interest rates; such controls were introduced during the war and were allowed to continue until the late 1970s – in some instances until the mid-1980s. It recommended a regime of stable exchange rates but, in the event of a fundamental external disequilibrium, it proposed that the exchange rate should be adjusted rather than sacrificing output and employment to a fixed rate.

16. The Royal Commission supported the expansion of government expenditure to prevent or mitigate the impact of recessions and depressions. To quote its report: ‘The appropriate policy to prevent or to meet a depression calls for the co-operation of other authorities as well as those who direct monetary policy. In general, the proper policy for governments to pursue if a depression is developing is to expand public works, refrain from increasing taxation and avoid a general contraction of government expenditure, even although deficits are incurred. When conditions have improved as private enterprise revives and full employment is approached, the proper policy is to contract public works expenditure, maintain or increase taxation, budget for surpluses, and reduce the debt which has been incurred through the depression policy. We emphasize the view that the policy which we have outlined above is one requiring action in prosperous times, as well as in times of depression.’ It added the important point that ‘If an expansion of central bank credit is to be successful in promoting recovery, the credit must be used, and this comes about mainly through government spending as a supplement to private spending.’ (Royal Commission Report, p. 209-10)

17. It argued further that ‘The proper policy for the Commonwealth Bank, as the depression developed, was one of expansion, using any necessary powers in that direction, and enabling the trading banks to do their share. As conditions improved, the proper policy

was to cease expanding credit, and, if necessary, to contract, using any appropriate powers to bring the trading banks into line.’ (Report of the Royal Commission, pp. 209-11). On the future role of the Commonwealth Bank as the nation’s central bank, the Royal Commission proposed that ‘The Commonwealth Bank should be in a position to give a lead which the trading banks and other financial institutions will follow, and if necessary to give assistance in its capacity as the lender of last resort. To do this successfully, it must possess ample resources which it can use at its discretion, its prestige must stand high, its capacity for leadership be proved and recognized, its policy be understood and accepted, and its powers be such that in the last resort it can enforce its policy. On their part, the trading banks and other financial institutions must co-operate with the Commonwealth Bank. It should be open to them to discuss freely with the Commonwealth Bank any matter of common interest, and to make representations or criticisms on the facts disclosed to them, but in the end the responsibility must rest on the Commonwealth Bank to enforce its policy, and on the trading banks and other institutions to conform to the policy and to assist in carrying it out.’ (Royal Commission Report, p. 208)

18. This approach to macroeconomic policy, proposed by the Royal Commission in the 1930s, was followed throughout the immediate postwar decades. The recommendations of the Royal Commission’s report were sometimes cited by those planning the postwar economy. But, in reality, the policy approach taken after the war had many sources, the Royal Commission being only one of them. In fact, the monetary and financial controls that had been introduced during the war, and which were allowed to continue for some decades after the end of the war, owed more to continuing inflationary pressures – and to inertia – than to the recommendations of the Royal Commission.

19. The Campbell Committee took a different view from that of the Royal Commission, concluding from its work that ‘the community, while recognizing a government responsibility to ensure stability and confidence, was nevertheless receptive to the prospect of a more open and flexible financial system, substantially free of intrusive government controls and regulations.’ (Campbell Committee Final Report, p. xxvi) In consequence, the Committee’s work ‘led it to recommend the immediate or ultimate abandonment of a wide range of direct controls and a shift to almost total reliance on open market methods of intervention in domestic financial markets.’ It has also recommended that ‘reduced levels of intervention in foreign exchange markets, freer entry conditions to banking, and the disposal of some government-owned financial institutions. *In these areas the Committee is, in effect, asking that more confidence be placed in the disciplines and processes of the market.*’ (Campbell Committee Final Report, p. xxviii) Yet it is important to understand that, while recommending the abolition of direct controls and the greater use of market procedures for the conduct of monetary policy, the Campbell Committee (supported later by the Vic Martin Committee), wanted to see a tightening of the Reserve Bank’s oversight of prudential regulation for the purpose of maintaining financial system stability. The point was made by the Campbell Committee that ‘A stable overall environment is important – but it will not ensure that adequate prudential disciplines are observed by individual institutions. For this reason, and because of community concern for the small, risk-averse household investor, the Committee has looked critically at the effectiveness of the present system of prudential regulation of banks and other financial intermediaries, and in some areas has suggested *more* rather than less government involvement, although with emphasis on increased *flexibility* of regulation wherever possible.’ (Campbell Committee Final Report, p. xxix)

20. The Vic Martin Committee endorsed for the most part the approach that had been taken by the Campbell Committee, concluding as it did that 'the experiences of recent years underline the importance of a responsive and adaptive financial system for the meeting of community needs. The period has demonstrated the benefits which can be secured from the removal or relaxation of unnecessary or out-dated official constraints...Market-oriented policy...is seen as having considerable advantages for monetary policy purposes over the use of controls which bear directly on specific financial institutions...[T]he Group does not consider controls over bank interest rates as appropriate for either monetary policy or prudential purposes.' (Vic Martin Committee Report, p. 358-61)

21. As to the Stephen Martin Committee, it considered that there 'should be no winding back of the deregulatory changes that have occurred.' That said, the Committee went on to add that 'the experiences of the 1980s show, as the Campbell Committee suggested, markets are not always rational in their behaviour. A major role of government intervention lies in ensuring an adequate information flow to consumers. There is also a role in ensuring monopoly control is prevented and competition is strengthened. Finally, government intervention is essential to ensure an appropriate system of prudential control. Within the regulatory framework imposed by government, it will be a matter for the banks, operating in the market place, to deliver to customers and the Australian economy the wider range of benefits expected of deregulation.' (Stephen Martin Committee Report, p. 458-9) While, for the most part, the Stephen Martin Committee recommended that existing trends toward deregulation should be allowed to continue, and that extant procedures should remain in place for the time being, it foreshadowed that changes would have to be made if circumstances warranted them. Here, it had in mind, most especially, arrangements to ensure financial system stability – and especially the issue of whether there should be a mega prudential supervisor for all financial institutions, not only for banks, but also insurance, superannuation, building societies, credit unions and money market corporations (or merchant and investment banks). It also suggested greater regulation of the domestic payments system.

22. The Wallis Committee's major interest was to ensure that the 'ideal regulatory scheme' was in place. 'This', it said, 'requires a balance between preventing market failure and allowing financial markets to perform efficiently the functions for which they were designed.' While it supported deregulation as a 'general principle', the Wallis Committee freely acknowledged that 'the balance required and the environment in which the judgment is made may vary over time. Consequently, it is possible that a particular structure will not meet the objectives of regulation at all times and in all circumstances.' (Wallis Committee Final Report, p.14) While the Committee admitted that it had 'proceeded in the knowledge that the performance of the financial system relies heavily on maintaining free and competitive markets', it also believed that 'where such markets cannot alone meet performance objectives, it is essential to provide effective regulation by government. Regulation is necessary only to the extent that markets may fail, and then only where it can be demonstrated that the benefits of intervention outweigh its costs.' (Wallis Committee Final Report, p.15) Its recommendations to create a separate prudential regulator for all deposit-accepting institutions, including the insurance and superannuation industries; to enhance the Reserve Bank's responsibilities for financial system stability; and for greater regulation of the payments system, recognized that enhanced regulation in some areas of the

financial system was necessary. The establishment of the Australian Prudential Regulation Authority, the Payments System Board and the Council of Financial Regulators were all direct outcomes of the work of the Wallis Committee.

23. A question that naturally arises from a study of the various inquiries is the extent to which they were responsible for subsequent changes in government policy toward the monetary/financial/banking sectors. Here there is something of a chicken and egg problem. It could be argued that developments in these sectors were responsible for driving the momentum for a new inquiry, and that these developments would have led to changes in policy regardless of whether there was an inquiry or not. In other words, it is possible that it is not so much the inquiry that leads to policy changes, but rather that it is developments within the system that are responsible both for the setting up of the inquiry and for changes in policy. Experience in other countries, where somewhat similar changes were occurring as those in Australia, seems to suggest that inquiries in this country were not the critical initiating factor bringing about policy change.

24. The Campbell Inquiry may be taken as a good example of the complexity of this issue. It is often claimed, for instance, that the Campbell Committee was responsible for the deregulation of the Australian financial system and for the adoption of market processes. But the system of direct controls had been breaking down for some time before the Campbell Committee was established. The Reserve Bank began to conduct open market operations from the 1960s, though it was not entirely successful until bank interest rates were deregulated, government securities were marketed by tender, and the \$A was allowed to float. Interest rates on certificates of deposits were decontrolled in the early 1970s, interest rates on term deposits were deregulated in the late 1970s, and more flexible exchange rate regimes were adopted in the mid-1970s. The Campbell Committee did not recommend freely floating exchange rates but rather a managed float of the Australian dollar. As to the Wallis inquiry, most of the Committee's major recommendations were implemented soon after the Committee reported, but many of the issues had been canvassed – if not actually recommended – in the earlier report of the Stephen Martin Committee. Both these reports were influenced by the economic and financial circumstances of the late 1980s and early 1990s.

25. Just how significant the various inquiries were in bringing about reform cannot be answered definitively. What can be said is that the inquiries were important in providing a forum for public debate on relevant issues and that their reports provided arguments that could be rehearsed by those who supported policy reform. Governments, for example, could – and often did – refer to the conclusions of independent experts who made up the bulk of the membership of the inquiries. In other words, the recommendations of the inquiries were used by governments to buttress their case for reform. The report of one of the inquiries – the Stephen Martin Committee – commented on this issue. It adjudged that, 'In many cases, changes in government controls over the financial system followed major public inquiries. One method by which governments could exercise control over banks is by the creation of a central bank. Once seen as a radical move, this is now universal practice. Other steps include regulation.' (Stephen Martin Committee Report, p.459)

26. A final point arises from one of the recommendations of the Stephen Martin Committee. It recommended (recommendation 103) that 'the House of Representatives amend the

resolution of the appointment of the House Standing Committee on Finance and Public Administration to include a responsibility for reviewing the banking industry. The name of the Committee should be amended to House Standing Committee on Banking, Finance and Public Administration.’ In support of this recommendation, the Committee argued that there was ‘a need for continuing parliamentary oversight of the banking and financial services industries.’ It went on to say that the work of the Committee had ‘given the Parliament a valuable insight into their operation and interrelationship. It has provided a forum for those with concerns about the industry to air their problems and for the banks to correct misunderstandings and to respond.’ It was convinced that there ‘is value in this being a continuing process.’ It noted the existence and work of parliamentary banking committees in the United States and Canada; such committees ‘consider legislation, review its implementation, undertake general oversight and conduct inquiries into specific areas of concern. They ensure a continuing parliamentary contribution to the debate about the future of the banking systems.’ (Stephen Martin Committee Report, p.459) It was recommended that such a committee, were it to be established in the Australian Parliament, should have the following remit:

- ‘consider legislation (for example, there may well be legislation resulting from the recommendations made in this report);
- Conduct inquiries into specific areas of concern;
- and undertake general review work.’

It recommended that the Committee’s name should change from the House of Representatives Standing Committee on Finance and Public Administration to the House of Representatives Standing Committee on Banking, Finance and Public Administration. Such a change, it was argued, would better reflect the expanded role proposed for the Committee. It acknowledged that the expanded terms of reference would require an additional permanent staff position, the person ideally being an expert in the banking or financial services industry.

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