SAFETY AND SOUNDNESS: AN ECONOMIC HISTORY OF PRUDENTIAL BANK REGULATION IN AUSTRALIA, 1893-2008

A thesis submitted

in fulfilment of the requirements for the degree of

Doctor of Philosophy

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September 2016
DECLARATION

I certify that except where due acknowledgement has been made, the work is that of the author alone; the work has not been submitted previously, in whole or in part, to qualify for any other academic award; the content of the thesis is the result of work which has been carried out since the official commencement date of the approved research program; any editorial work, paid or unpaid, carried out by a third party is acknowledged; and, ethics procedures and guidelines have been followed.

Christopher Richards Berg, September 2016
ACKNOWLEDGMENTS

This thesis would not have been possible – or even probable – without the support of a number of people. A heavy burden has been laid on Professor Sinclair Davidson, my primary supervisor, who has been a constant source of academic and personal advice, intellectual challenge and reflection on this thesis and innumerable other topics through the course of my studies. My secondary supervisor Jason Potts has also been a source of much insight and questioning as the framework for the study took shape.

Many people have provided constructive and invaluable feedback. Richard Allsop’s happiness to read every manuscript I have placed in front of him is apparently limitless. Darcy Allen, with whom I developed the subjective political economy framework outlined in this thesis, has been an incomparable source of ideas and discussion. My fellow PhD students throughout this process – Aaron Lane, Trent MacDonald and Pete Gregory – have also been great sources of support. Also worth thanking are the anonymous reviewers on the two papers published in this thesis, whose advice has made those chapters significantly better.

I would also like to thank the Institute of Public Affairs (IPA), and particularly its executive director John Roskam, for the support granted for this project. First of note is the generous industry scholarship provided by the IPA, without which this project would not have gotten off the ground, and is a testament to the IPA’s work developing the next generation of free market intellectuals. Second is the support I have had while working for the IPA to complete the thesis, and the opportunities to travel to visit archives around Australia, to visit conferences, and to develop my thinking in a wide liberal framework. My economic and political philosophy has been shaped by the work I have done at the IPA. The research has also been made immeasurably easier by the Australian Postgraduate Award granted by
RMIT University. Other thanks must go to the extremely helpful staff at the Reserve Bank of Australia archives in Sydney and the National Australian Archives in Canberra.

Finally, and most importantly, my family. Bronwyn Hinz – now Dr Bronwyn Hinz – wrote her own PhD at the same time I produced this one, at the same time as being a wonderful mother to two young boys, Leonard and Walter. Her patience, understanding, sympathy, and forbearance are the only reason these words have been written. It is to her and our children that this thesis is dedicated. How could it be otherwise?
The following articles have been published from this thesis:

- Parts of Chapter 3 and Chapter 4 have been published as Berg, C 2015, 'The Curtin–Chifley Origins of the Australian Bank Deposit Guarantee', *Agenda*, vol. 22, no. 1, pp. 21-43.

- Parts of Chapter 5 and 6 have been published as Berg, C 2016, 'The Campbell committee and the origins of 'deregulation' in Australia', *Australian Journal of Political Science*, viewed 29 August 2016, <http://dx.doi.org/10.1080/10361146.2016.1219315>.

- Parts of Chapter 2 are available as a working paper, co-authored by and jointly developed with Darcy Allen as Allen, DWE and Berg, C 2016, 'Subjective Political Economy' SSRN, June 21 <http://ssrn.com/abstract=2799032>.

The following publications are referenced but not submitted for examination:


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ABSTRACT

This thesis is an economic history of the prudential regulation of banks in Australia between the crash of 1893 and the global financial crisis (GFC) of 2008. It applies two theoretical frameworks in order to characterise the institutions of prudential regulation and identify the sources of regulatory change over the period studied. The institutional possibility frontier is used to characterise regulatory regimes. Three common models of political economy – public interest, public choice, and ideas – are used to identify the causes of changes in those regimes. The thesis uses unexamined and underused archival sources to refine and expand our understanding of regulatory change in the period studied.

As policymakers in the wake of the GFC conceive of new approaches to prudential regulation of banks, it is important to understand where and how prudential regulation has been adopted in the past. Yet no general study of the history of prudential regulation of banks in Australia exists. This thesis is an attempt to provide that study. Prudential regulation in the period covered has swung between extremes: first, from a laissez faire approach to regulatory control, where regulation was both light and poorly administered, to a system of financial repression, where prudential regulation was both heavy and thorough. As the Australian financial market has been opened to foreign entrants and global competition since the 1980s, prudential regulation has been expanded, formalised, and internationalised. Prudential regulation of banking offers a window into broader changes in the way Australian governments have controlled economic activity.

The thesis makes a number of significant contributions to knowledge. First, it finds that, contrary to later claims by the Reserve Bank of Australia, the Curtin government established a bank deposit guarantee in 1945, and was understood to have done so by the parliament and the Commonwealth Bank, which was to administer the guarantee. Second, it offers a new history of the origins of the deregulation movement
in Australia, by situating the Fraser government’s 1979 Campbell committee inquiry into financial regulation in the context of a building society crisis and a contest between two visions of Australia’s economic future. Third, it offers the first account of Australia’s rapid adoption of the international Basel Capital Accords in 1988. Fourth, it provides a new interpretation of the development of prudential regulation after the introduction of foreign banks in 1985, which helps identifies the ideological drivers and economic pressures that led to the (re)creation in 2008 of the Australian bank deposit guarantee scheme by the Rudd government.

The thesis also develops a new theoretical approach to analysing changes in political economy. The ‘subjective political economy’ framework aims to integrate diverse ideological viewpoints and motivations into an institutional model of regulatory control. By characterising institutional choices as a trade-off between subjective costs, the thesis shows how changing ideas about the purposes, possibilities, and risks of prudential control drove regulatory changes. Furthermore, the framework provides a way to understand institutional innovation as changing perceived costs places pressure on the institutional choices available.

The thesis finds that the history of prudential regulation of banking in Australia was driven by changing perceptions of the relationship between the state and the economy and the responsibilities of governments to bank depositors. Australians have long seen the relationship between banking and the state as a window to understand political economy more generally. By bringing the Basel adoption and prudential regulatory changes to the front of any account of the period of financial regulatory reform, we can see how the reform movement of the 1980s was characterised less by ‘deregulation’ and more by regulatory evolution and expansion. A reassessment of the changes in prudential regulation since the
crisis of 1893 should inform our understanding of the trajectories and development of Australia’s regulatory state.
ACRONYMS

AAPBS - Australian Association of Permanent Building Societies
ACCC - Australian Competition and Consumer Commission
AFIC - Australian Financial Institutions Commission
ALP – Australian Labor Party
ANZ – Australia-New Zealand Bank
APRA – Australian Prudential Regulation Authority
APRC – Australian Prudential Regulation Commission
ATPC - Australian Trade Practices Commission
BCBS – Basel Committee on Banking Supervision
BIS – Bank of International Settlements
CBA – Commonwealth Bank of Australia (after 1959)
CFS – Council of Financial Supervisors
CPD – Commonwealth Parliamentary Debates
DTI – Deposit taking institution
FSF – Financial Stability Forum
FSU – Financial Sector Union of Australia
GFC – Global financial crisis
GSB – Government Savings Bank of New South Wales
IMF – International Monetary Fund
ILSA - International Lending Supervision Act
IPA – Institute of Public Affairs
IPF – Institutional possibility frontier
LGS ratio – Liquid assets and Commonwealth government securities ratio
MPC – Monetary policy committee of the federal Cabinet
NAA – National Archives of Australia
NBFI – Non-bank financial intermediary
NCD – Non-callable deposit
NSW – New South Wales
PAR – Prime asset requirement
QPBS – Queensland Permanent Building Society
RBA – Reserve Bank of Australia
SBV – State Bank Victoria
SRD – Statutory reserve deposit
UAP – United Australia Party
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1 INTRODUCTION

1.1 Introduction
Between the 1890s and 2008 the Australian system of prudential regulation of banking went from an almost entirely unregulated free banking system to a system where prudential regulation was both heavy and thorough. During that time, Australian banks and non-bank financial intermediaries (NBFIs) experienced two major depressions, at least two major building society crises, and a global financial crisis. Australian regulatory policy swung between *laissez faire*, to an attempted nationalisation of the banks, and then to a political-economic system that has been characterised as the “regulatory state”, where regulatory frameworks are now determined as much by international coordination as domestic politics.

Yet there has been no general study of the trajectory of prudential regulation in Australian history. This absence is surprising because of the centrality of banking crises and banking regulation to Australia’s economic and political past. From the crash of 1893 to the global financial crisis (GFC) of 2008, the safety and soundness of Australian banks has been a window through which Australians have conceptualised the state’s involvement in the economy. This thesis attempts to provide that study. It does so at a time when the institutions of prudential regulation are subject to a great deal of policy and scholarly attention. Since the GFC prudential and monetary authorities have experimented with ‘macro-prudential’ policies to prevent the build-up of systemic imbalances in the financial sector. A new understanding of the origins and arc of prudential policy over time should inform that discussion.

This thesis is the first attempt to apply an institutional perspective on the development and evolution of prudential regulation in Australia. Djankov et al. (2003) provide a framework whereby institutional arrangements can be compared between economic systems and over time. My concern is to understand
the factors which lead to institutional variation by reference to economic theories of public policy formation: public interest, private interest, and ideas. By taking a long historical view on these models, the thesis is able to adjust our understanding of the relationships between these factors and their historical context. Furthermore, the thesis modifies and integrates these two frameworks, offering a significant theoretical advance in institutional economics titled “subjective political economy”. This was developed jointly with a fellow doctoral candidate, Darcy Allen, and has been published as a working paper (Allen and Berg 2016). This work is part of a larger research program investigating institutional political economy at RMIT University (Allen forthcoming; Berg and Davidson 2015; Davidson 2013, 2014, 2016; Davidson and Potts 2015, 2016a, 2016b; Lane forthcoming; MacDonald 2015).

The thesis also makes a number of significant contributions to knowledge about the history of Australian banking and NBFIIs and Australian economic reform more generally. First, it sheds new light on the origins of the Australian bank deposit guarantee scheme. It finds that the Curtin-Chifley government believed, and informed the Australian parliament and the Commonwealth Bank, that it had introduced a bank deposit guarantee with the passing of the Banking Act 1945 - that is, 63 years before the Rudd government introduced its own bank deposit guarantee scheme. Second, it reorientates our understanding of the source of financial regulatory change in the 1980s by seeing it as the result of an ideological contest between the Whitlam and Fraser governments. The Fraser government instituted the Campbell committee in response to an internal campaign to proclaim part of the Whitlam government’s Financial Corporations Act, which would have imposed the same regulation on NBFIIs that the Banking Act imposed on banks. Third, the thesis provides the first account of Australia’s involvement and integration with the Basel Committee on Banking Supervision between 1974 and 1988. Despite being an outsider to the Basel Capital Accords process, Australia was one of the world’s most rapid adopters of the accords, and this demands explanation. Fourth, the thesis offers a reinterpretation of the
development of prudential regulation in the 1980s, focusing on the formalisation of prudential controls which were brought on by the introduction of foreign banks and the consequent end of informal, cooperative regulatory relationships. By bringing the Basel adoption and prudential regulatory changes to the front of any account of the period of financial regulatory reform, we can see how the reform movement was characterised less by ‘deregulation’ and more by regulatory evolution and expansion.

This chapter lays out the scope and method of the thesis. First I provide a rationale for studying in 2016 the long trajectory of regulatory change. Episodes in banking regulation have been central to perceptions of Australian political economy. Looking at one regulatory area (prudential regulation) in one significant industry (bank and bank substitutes) at one level of government (the Commonwealth) offers a window into broader economic and regulatory change over the last century. From that I formulate the research questions for the thesis. I then turn to the method of the thesis as an analytical history using the tools of institutional economics. In the following section, I discuss the sources utilised by this thesis, and the strengths and weaknesses of some contemporaneous material. Finally, I offer a roadmap to the thesis, from the crash of 1893 to the GFC, and a preview of the thesis findings.

1.2 Rationale
In recent decades increasing scholarly interest has focused on how regulation shapes and is in turn shaped by political economy. This interest has come from two directions. First, economists have directed their attention to the factors that influence institutional design, and the effects an institutional framework can have on market and non-market activity. The field of new institutional economics (Buchanan 1990; Buchanan and Tullock [1962] 1999; Coase 1960; Djankov et al. 2003; Greif 2005; North 1981, 1990a, 1999; Olson 1965, 1982; Ostrom 1990; Shleifer 2005; Tullock 2006) has focused on the social and legal norms and rules that govern economic and political decisions. Second, political scientists have been increasingly interested in changes in how the state governs. This project is grouped under the
study of the ‘regulatory state’ – a model of political economy where the state exercises power over 
economic activity through regulatory control rather than direct ownership. This area of study focuses 
on the institutional and political changes that such a shift in governance has brought about (Braithwaite 
1999; Glaeser and Shleifer 2003; King 2007; Majone 1999, 2010; Mitnick 1980; Moran 2003; Shleifer 
2012).

These two streams of research help us explore one of the puzzles of recent political and economic 
history. Political historians tend to describe the period of the 1980s and 1990s as a period of 
deregulation, particularly in the field of financial regulation (Kelly 1992; Meleagenis 2006; Tingle 2013). 
Yet at the same time, in the second decade of the twenty-first century there is a popular and political 
impression that the Australian economy is over-regulated. The Rudd government introduced the first 
Commonwealth Minister for Finance and Deregulation in 2007. The Abbott government created an 
Office of Deregulation in the Department of the Prime Minister and Cabinet in 2013, and hosted annual 
“red tape repeal days” to remove unnecessary and burdensome economic regulations from the statute 
books. This impression that the Australian economy is highly regulated despite a much-vaunted period 
of deregulation reflects the findings of political science scholars who have seen in the global reform 
movement of the 1970s-1990s not deregulation but the growth of a regulatory state. Jordana and Levi-
Faur (2004, p. 1) write that “In an era in which regulation has become synonymous with red tape, and 
deregulation has become a major electoral platform of the New Right, regulatory authorities have been 
created in unprecedented numbers and with unprecedented autonomy.” In a previous work I argued 
that:

The modern state forges a compromise between Robert Nozick’s ‘nightwatchman state’ and the 
welfare state by matching privatisations and liberalisations with regulatory expansion, rather than
retreat. Governments have shifted away from the provision of services, to the regulation of those services. (Berg 2008, p. 5)

In 2010 the Reserve Bank Governor Glenn Stevens characterised the trajectory of changes in financial regulation as follows:

The regulatory cycle has come fully around. After two or three decades of liberalisation and allowing markets and private agents in the financial sector more sway, the international debate has of late been consumed with issues of financial regulation: how to re-design it, and generally increase it. (Stevens 2010)

One possible measure of the growth in regulatory control is the volume of legislation passed every year. Pages of legislation passed is a highly imperfect measure of regulatory growth, as it does not take into account changes in formatting, language and, most critically, legislation which reduces the regulatory burden. Nor it is necessarily the case that longer legislation is more burdensome. Nevertheless, it is a reasonably direct measure of legislative change, and is seen as suggestive of regulatory growth over time (Berg 2008; Novak 2013). Between 1910 and 1970 the Commonwealth parliament passed on average 74 acts of parliament per year, totalling an average of 353 new pages of legislation per year. Between 2000 and 2010 however, the Australian parliament passed an average of 162 acts of parliament, averaging 6,029 new pages each year (Berg 2008; Novak 2013). While it might be objected that this reflects the centralisation of policy authority at the Commonwealth level, Novak (2013) shows that there has been a similar increase in legislative activity in the Australian states. Following this approach, a provisional assessment can be applied to the banking industry. When it was first introduced, the Banking Act 1945 was 26 pages long. Incorporating amendments made as recently as July 2015, the Banking Act 1959 has now ballooned to 239 pages. The Commonwealth Bank Act 1945, which established the central bank as a monetary and prudential authority, was 35 pages long. Those functions
have been divided into the Reserve Bank Act (69 pages long in 2015) and the Australian Prudential Regulation Authority Act 1998 (78 pages long).

Likewise, anecdotal reports of increased regulatory burden after the deregulation period are widespread. As Adams et al. (2006) point out,

> Australia is over-regulated in the area of financial services, which leads to anti-competitive burden on compliance costs. There is limited empirical evidence of these issues but anecdotal evidence is overwhelming of the growth in costs in the financial services industry.

For example, the Australian Bankers Association (ABA) told the Howard government’s 2005 Reducing the Regulatory Burden on Business Taskforce that “the regulatory burden faced by banks has increased markedly in recent years. This has led to a substantial rise in compliance costs and affected the way financial products are offered to customers” (Australian Bankers' Association 2005, p. 4). One bank informed the ABA that the compliance costs of regulation had doubled every five years since 1994-95. Regulatory compliance was taking an increasing share of board and senior management time, growing from 5 per cent in the mid-1990s to between 20 and 25 per cent in 2005. The ABA particularly nominated the internationalisation of the regulatory burden, which included extra-territorial compliance requirements such as the recently passed Sarbanes-Oxley Act, as well as Australia’s adoption of the Basel Capital Accords. In its 2015 submission to the Abbott government’s Financial System Inquiry, the ABA claimed that “banking is one of the most regulated industries in Australia” (Australian Bankers' Association 2014, p. 12). Even discounting the ABA’s interest in easing the regulatory burden on its members, this is strikingly counter to the popular perception of a deregulated financial sector. The incongruence presents an opportunity for scholarly study.
1.2.1 Why prudential regulation?

This thesis focuses on banking policy because of the centrality that banking policy has played in the development of Australian political economy. The crash of 1893, the Great Depression, the Chifley government’s attempted nationalisation of the banks, and the introduction of foreign banks into Australia in 1985 all presaged and were driven by large scale political and economic changes. The GFC directed attention to banking once again, although the long run significance of that crisis is yet to be determined. Prudential regulation and supervision is defined as the practice of “government regulation and monitoring of the banking system to ensure its safety and soundness” (Mishkin 2001, p. 1). Prudential policy has been chosen because of its conceptual interest, its relationship to challenging political questions like the “too big to fail” problem, and because of the role that bank failures have played in Australian political history. Furthermore policy moves towards macroprudential regulation in recent years give the focus on the trajectories of prudential regulation added salience.

What do I mean by regulation? Mitnick (1980, p. 20) points out that regulation can be seen as a broad process, as “the intentional restriction of a subject’s choice of activity, by an entity not directly party to or involved in that activity.” Thus regulation can be imposed not just by the government but by third parties such as industry associations and standards boards. Mitnick’s definition captures so-called “grey letter law” or “quasi-regulation” - restrictions on activity where the boundary between voluntary action and state coercion is not clear (Commonwealth Interdepartmental Committee on Quasi-regulation 1997). However, even limiting consideration of regulation to that imposed by the Commonwealth government and its agencies on banks, it is important to note that banks are regulated in a myriad of ways, from economy-wide workplace regulation to finance industry specific disclosure standards and financial advice requirements. Limiting our investigation to prudential controls imposed on banks
provides a conceptual boundary from which more general findings in political economy might be derived.

Finally, the interest of this thesis is prudential regulation as it applies to banks, not all entities that are supervised for prudential purposes. At the turn of the twenty-first century, prudential regulation was administered by the Australian Prudential Regulatory Authority (APRA) which applied prudential regulation to “authorised deposit institutions” (of which banks are one) as well as general, life and health insurance funds, and superannuation (pension) funds. Each of these regulatory categories have their own histories. For purposes of manageability, the thesis limits its consideration of prudential regulation to banks. NBFIs such as building societies, credit unions, friendly societies and hire-purchase firms play a significant role in the history of banking regulation. While they enter the thesis where necessary, this thesis does not purport to offer a comprehensive history of NBFi regulation.

1.3 Research aims and objectives
With this in mind, it is the objective of this thesis to look at regulation of the financial sector as an institutional process. It seeks to characterise broad changes in political economy and identify the factors underpinning those changes. Thus the research questions which follow are:

1) How have the institutions of prudential regulation changed in Australia?
2) What were the political, economic, and ideological drivers of prudential regulatory change?
3) How have the justifications for prudential regulation and the mechanisms by which regulation is implemented varied in response to, and been dependent upon, these drivers?

In this way, the thesis seeks to describe regulatory change as an iterative process. Understanding how and why regulation has changed in the past helps us identify the drivers behind regulatory change in the present. As North (1990a) has pointed out, institutions are path dependent. Regulatory regimes of the
past shape the regulatory regimes of the future. Path dependencies may lead to the build-up of social rigidities and institutional sclerosis (Olson 1982), or impose costs and prevent innovation (Acemoglu and Robinson 2012). The thesis seeks to identify aspects of the political-economic framework that are historically contextual - that is, those features of the present which are contingent on the past.

The content of a regulatory framework is shaped and defined by the political circumstances of its development. An understanding of the political coalitions and compromises that forged our contemporary regulatory framework is essential. First, it sheds light on the purpose of those regulations. The political interests which led to their formation may have shifted or been eliminated but the regulations themselves remain. Second, it counsels us that existing regulation and regulatory approaches ought not to be treated as inviolate; if regulation was not constructed in an objective and scientific environment but in a political environment, that implies that society should at least reassess the desirability of those extant regulations. Third, and most important, understanding how politics, ideology and interests can shape regulation is a fundamental requirement if we are to achieve ‘robust political economy’ (Boettke and Leeson 2004; Leeson and Subrick 2006; Pennington 2011) - a regulatory framework which can deal with both the incentives problems described by the public choice school of economics and the information problem described by Hayek (1945).

1.4 Method and sources

1.4.1 History as method

This thesis offers an analytic narrative history of the development of the institutions of prudential regulation in Australia. History is “an intellectual effort to make sense of past human experience” (Curtis 1982, p. 55), and has intrinsic interest. However, there are also theoretical and methodological reasons to pursue this approach. The analytic narrative approach marries the analytic tools of economics and political science with the narrative form more commonly used in history, seeking to apply models of
action to the singular, hard to quantify, ‘messy’ big events of the past (Bates et al. 2000; Bates 1998). In analytic narrative, an explicit theory helps ‘distil’ the narrative. The application of theory is considered successful when it can explain historical events without needing too many explanatory factors outside the model. “If one must appeal too often to forces outside the model, then the theory must be rejected” (Bates et al. 2000, p. 687). Bates et al. (2000) counsel against the use of off-the-shelf models for analytic narrative, as these models are best suited for static or stylised models that provide little illumination when applied to the human activity in a diverse context. In this thesis I start with off-the-shelf models and modify them to suit the task at hand. However, the resulting framework is readily adaptable to a much wider set of historical events.

A further reason for choosing the historical method into social science investigation is its ability to illuminate and extend theoretical findings in institutional economics. A historical approach is necessary to identify the path dependencies that underpin institutional arrangements (Boettke et al. 2013; Denzau and North 1994; North 1999). Institutional stickiness, driven by the interaction of formal institutions with informal institutions such as norms and beliefs, prevents otherwise desirable institutional changes from being made. A close examination of the trajectory of institutions, formal and informal, is needed to identify those path dependencies.

Methodological considerations also direct this investigation towards a historical inquiry. Yin (2014) argues that when a researcher has no control over or access to the events or phenomenon that they are seeking to understand, history is the preferred research method:

The distinctive contribution of the historical method is in dealing with the ‘dead’ past - that is, when direct observations of the event(s) being studied are not possible and when no relevant persons are alive to report, even retrospectively what occurred. The historian must then rely on primary
documents, secondary documents, and cultural and physical artefacts as the main source of evidence. (Yin 2014, p. 12)

In this thesis, access to the events is only partial. While there are policy actors still alive able to testify about some of the events considered in this thesis, that is not the case for the expanse of which the thesis covers. Further, the historical investigation here is explicitly qualitative, rather than quantitative. The thesis is interested in the how and why of institutional change, and drawing tentative chains of causality between ideas, interests and policy regimes. Qualitative studies, in the words of Huberman and Miles (1994, p. 434):

are especially well suited to finding causal relationships; they can look directly and longitudinally at the local process underlying a temporal series of events and states, showing how these led to specific outcomes, and ruling out rival hypotheses. In effect, we get inside the black box; we can understand not just that a particular thing happened but how and why it happened.

1.4.2 Primary sources

In keeping with this local focus, this thesis makes extensive use of the primary and secondary literature, including contemporary archives from the Commonwealth government Cabinet, the Reserve Bank, and the Treasury. A number of these archival sources which have been either little used by scholars or unavailable until recently. In some cases biographers have been granted access to closed records but scholars working on banking policy have not. Cabinet records are now publicly available up until 1991. The use of these sources has offered up new insights and new approaches to what were seen as largely settled narratives about regulatory change. These provide partial but often provocative accounts of the arguments and debates waged at the highest level of government. Cabinet submissions also offer the views of government departments, giving a picture of the bureaucratic disagreements on major policy. The minutes of Curtin-Chifley Cabinet discussions, despite having been available to scholars for some
decades, have brought out a number of insights about the 1945 Banking Act. Likewise, the submissions, memoranda and decisions of the Whitlam, Fraser and Hawke Cabinets have shed light on how the ideas and intentions of banking regulation changed. By comparing these records to current events we can see how governments responded to political and economic pressure.

Other archives have been able to corroborate and expand on these insights. For example, the argument this thesis makes on the origins of Australia’s deposit guarantee is confirmed by documents from the Cabinet, which outlines the political significance of the guarantee, the Commonwealth Bank, which was required to provide the guarantee, the Attorney-Generals’ Department, which drafted the legislation, and the Treasury department, which prepared the policy. The thesis makes particular use of Reserve Bank of Australia (RBA) archives and Treasury archives, through which we can see what fed into policy decisions, how those decisions were translated into implementable policy, and give us a picture of policy development below the threshold of Cabinet-level decisions. One example of the latter is the relationship between the Basel Committee on Banking Supervision and the RBA, of which there is little trace in Cabinet archives but plays a central role in the formulation of prudential policy. These archives allow us to confirm and challenge many of the claims made in the secondary literature. They have been particularly invaluable as a way to see past the broad political economy questions that have been amply covered in memoirs and biographies of key players. Thanks to a long-running debate over who can be credited for instigating the process which led to financial deregulation (Ayres 1987; Buckley 1991; Errington and Van Onselen 2007; Fraser and Simons 2010; Howard 2010; Wallace 1993; Weller 1989), historians are already well-informed about the Cabinet level formation of the Campbell committee. The weaknesses in these accounts lies in their episodic nature - financial regulation disappears from these biographical narratives as quickly as it enters. Non-Cabinet government archives allow us to see how
those decisions were implemented, changed, and subjected to constant adjustment after they were made.

I decided early in the research project not to conduct interviews, but limit my data collection to archival and printed sources. This decision was made for two reasons. The first reason was the need to limit the scope of the study, given the large expanse of history to be covered. The second was that the field has been well-tilled. A number of published case studies (Bakir 2002, 2003, 2005; Fitzgibbons 2006; Harper 1985; Martin 1999) make extensive use of interviews with policy actors, particularly those which have focused on recent decades. For instance, in his examination of the political drivers underpinning the Wallis inquiry, Bakir (2002, 2003, 2005) interviewed a number of political and public service participants in banking and NBFI policy in the late 1990s. Martin (1999), who was a political participant himself, interviewed both Paul Keating and Gough Whitlam, as well as senior ministers, party officials, political advisors and bankers, for his doctoral study on financial deregulation and the Hawke-Keating governments. Harper (1985) provides an invaluable interview with John Howard on the origins of the Campbell committee report. Fitzgibbons (2006) interviewed bank officers reflecting on the Campbell committee. Other perspectives have been well-covered in memoirs and biographies. While no doubt it would be possible to glean further insights from those policy actors who are still alive, a focus on the documentary evidence was judged to be more profitable, particularly given the fact that much of that evidence had not yet been sorted through by scholars.

1.4.3 An overview of the secondary literature

Much has been written on banking policy throughout the twentieth century. However, there is no twentieth century counterpart to Butlin’s (1953) exceptional history of Australian monetary and banking policy and politics in the nineteenth century. There are nonetheless some valuable overviews which
seek to place banking in its political and economic context. Here I provide a survey of the substantial secondary literature on the subject that informs this thesis in order to give context to my contributions. The paper by Maddock (2013) is a recent and valuable contribution which sets the general story about the trends in financial repression and liberalisation, which is complemented by Bora and Lewis (1997). Brief overviews of changes in prudential regulation specifically are offered by Thomson and Abbott (2000) and Hogan and Sharpe (1990a). One particularly useful book length study – the only analogous volume to Butlin (1953) in scope and ambition – is the history of corporate collapses in Australia by Sykes (1988), which, when read with political and economic histories both enlightens and enlivens the narrative of economic and regulatory change. This is particularly important when we see regulatory change as part of a political process, in which exogenous events affect the decisions of policymakers.

Otherwise, the history of Australian banking and regulation has been told through the histories of individual organisations. First among those is Australia’s central bank. The preeminent example of a comprehensive organisational history is Schedvin (1992), which covers the Commonwealth Bank / RBA from the Second World War to the start of the 1980s, and has no parallel in its detail. It remains the most valuable secondary source for the period it covers. The history of the central bank before the Second World War is most valuably covered by Giblin (1951), but also worth noting are Gollan (1968) and Jauncey (1933). The Commonwealth Bank published its own history of its wartime activities (Commonwealth Bank of Australia 1947). Bell (2004) picks up the story where Schedvin (1992) left off, and Cornish (2010) fills in some further gaps. While each are important contributions to knowledge, these works tend to focus on the monetary approach of the central bank rather than its prudential responsibilities, and their coverage leaves much room for original explorations. The best exploration of the Commonwealth Treasury is Whitwell (1986), although Weller and Cutt (1976) is also worth noting.
Some of Australia’s best histories have been the commissioned histories of firms, and banks among them. Blainey’s history of the National Bank (1958) is a classic, but the Butlin (1961) and Merrett (1985) histories of the Australia-New Zealand (ANZ) bank are also highly valuable. There are also some limited histories of specific financial sectors. Consumer credit is covered by van der Eng (2008), Thomson and Abbott (1998) trace the ups and downs of the building society sector, and Runcie (1969) looks at hire-purchase firms. Textbooks offer snapshots of the prevailing principles of regulation and the shape of the financial sector at the time they were written. Thus Heinz Arndt’s series (Arndt 1957, 1960; Arndt and Blackert 1977; Arndt and Harris 1965; Arndt and Stammer 1973) is significant, as well as Harris (1975) and Hirst and Wallace (1964). Australian monetary policy and practice is dealt with in a number of useful monographs, including Jolley (1978), Porter and Burns (1978), Rowan (1980), and Guttmann (2005).

Each episode studied in this thesis has particularly important sources, all of which shed light on the intellectual, political, and institutional factors behind regulatory change. A few are worth briefly noting here. For example, the dissertation by Bakir (2002) covers the political drivers behind the formation of the Wallis Inquiry, but its narrow focus means it is unable to situate that inquiry into the broad trajectories of Australian political economy. Goodhart (2011) offers an overview of the introduction of the Basel Capital Accords but without an Australian focus. A comprehensive political history of bank deregulation from the Labor Party’s perspective is provided by Martin (1999). Love (1984) and Kuhn (1985) help situate banking regulatory changes during the Second World War in the economic thought of the Labor movement. Markwell (2000) and Millmow (2010) offer the definitive stories of the development of Keynesianism in Australia, although with a limited focus on banking. Banking during the Great Depression is covered by Schedvin (1973a). Sutherlin (1980) is the best discussion of the origins of the 1937 Royal Commission. The two official histories on the Australian economy during the Second World War (Butlin 1955; Butlin and Schedvin 1977) are unparalleled for their detail on the specifics of
financial regulation in that period. The bank nationalisation controversy has its own dedicated history (May 1968), although it only lightly covers the questions studied in this thesis.

Much evidence for the political factors behind financial regulation has to be gleaned from biographies and memoirs. Ben Chifley looms large in this thesis, as the Labor representative on the 1937 Royal Commission into Monetary and Banking Systems, the Treasurer who brought in the Banking Act 1945, and the Prime Minister who attempted to nationalise the banks in 1947. The Chifley biography by Crisp (1960) has a sharper policy focus than Day (2001), despite the latter’s encyclopaedic account of Chifley’s life. James Scullin, another central figure in the first half of the thesis, is well profiled by Robertson (1974). Ted Theodore, Scullin’s treasurer and the ‘first Australian Keynesian’ is sketched most usefully by Young (1971). Biographies assume substantial importance the further into the twentieth century we travel. The argument between John Howard and Malcolm Fraser as to who was the most responsible for the Campbell Committee has given us rich accounts of the Fraser Cabinet in Howard (2010) and Fraser and Simons (2010), complemented by biographies of Fraser (Ayres 1987; Weller 1989), Howard (Errington and Van Onselen 2007), Phillip Lynch (Buckley 1991) and John Hewson (Wallace 1993). Nevile (2002) offers a rare account of the Campbell committee that is not driven by personality politics. An understanding of economic reform under the Hawke government is helped by Hawke (1994) and Edwards (1996). Other useful autobiographies have included those by H.C. Coombs (1958) and Gough Whitlam (1985). These accounts are inevitably partial and retrospective, but still give us a picture into how policy actors wished to be seen and remembered, and how they believed their decisions should be viewed.

Contemporaneous debates over banking and regulatory policy can be found in the Economic Record, which is particularly useful on the Royal Commission and Campbell committee, as well as industry
journals such as the *Australasian Insurance and Banking Record*. The Reserve Bank has produced a number of working papers covering aspects of Australian financial regulatory history, as well as two valuable bibliographies. Newspapers provide a wide range of political views on banking and financial policy; particular use has been made of the *Age*, the *Argus*, the *Australian Financial Review*, and the *Sydney Morning Herald*. It is true however that newspaper reports have to be treated with caution. Media reports are endogenous to policy formation. In this sense they are both primary and secondary sources.

There is a basic tension then between the media as record of past events and the media as integral to them. The analyst, however, can simultaneously utilise media sources as information source and analyse the media’s role in the public and private policy debate. (Pokarier 2000, p. 22)

Here we use media reports as a documentary source for events and as a contemporaneous window into the perceived political and economic drivers for regulatory change. Public policy is not conceived or implemented in a vacuum. The considerations which inform policy change can be partially identified through official documentation – such as press releases, inquiry reports and speeches by policy actors. However alternative explanations for policy change often must be teased out through scattered sources. Contemporary sources, used advisedly, offer invaluable glimpses at the political factors underpinning policy change. The need to use official records and informal reporting is particularly obvious when timelines conflict with secondary sources. Media accounts have been used in this thesis to confirm or challenge claims made about the political origins of public policy change. Official government documents, including inquiry submissions and minutes of evidence, are also used to examine the beliefs of participants and dominant intellectual theories governing their views. In this way, the Commonwealth and state Hansards have been useful and necessary sources as well.
1.5 Plan of the thesis

In order to identify how the justifications and factors underpinning prudential regulation have evolved over time, the thesis is structured in a chronological narrative order. Chapter Two first outlines the theoretical framework applied in the thesis. As Pokarier (2000, p. 20) notes, “qualitative approaches ... run the risk of defaulting into undisciplined descriptions if not closely guided by an appropriate body of theory” and close attention to theory defines the analytic narrative approach (Bates et al. 2000; Bates 1998). The thesis combines two economic models of regulatory institutions and change. The first is the new comparative economics articulated by Djankov et al. (2003). The second is a set of alternative models of political economy derived from Kroszner (1999). The two models allow us to characterise regulatory frameworks and then account for changes in those frameworks over time. The theoretical findings from this chapter have been published as a working paper (Allen and Berg 2016).

The narrative of the thesis is divided into four parts. In Chapter Three and Chapter Four the thesis explores the development of the institutional structure which imposed financial repression with the 1945 Banking Act. Starting with the crash of 1893, it looks at the importance of the Great Depression, the 1937 Royal Commission and the Second World War in forming the ideas and interests which led to the establishment of a central bank and regulatory governance. Chapter Four focuses on the development of a deposit guarantee in the 1945 Banking Act. A version of Chapters Three and Four has been published as Berg (2015b).

Chapters Five and Six trace the origins of the dismantling of the regulatory apparatus that had been established by the Banking Act. This regulatory change was not linear. Chapter Five looks at the role played by the Whitlam government’s Financial Corporations Act 1974 in establishing the political and economic context for later regulatory change under the Fraser and Hawke governments. Chapter Six reassesses the importance of the Campbell committee in light of that prior legislative program, as well
as integrating the building society crises of the 1970s into the story of the reform era. It offers a new interpretation of the Campbell committee’s perspective on prudential regulation in that context, and has been published as Berg (Forthcoming).

Chapters Seven and Eight look at the introduction of foreign banks into Australia and the regulatory changes this brought about. Chapter Seven argues that the small number of domestic banks allowed regulatory relationships to be informal and clubbish. Treasurer Paul Keating’s dramatic announcement in 1985 that fifteen new banks would be granted licences to operate in Australia brought about a rethink in the governance and approach to prudential regulation in Australia, leading to a new formalisation of regulation. In this light, Chapter Eight offers an explanation for the rapid introduction of the Basel Capital Accords in Australia despite Australia not being a party to the G10: Basel offered an off-the-shelf approach to prudential standards to regulators that were seeking new regulatory institutions.

Chapters Nine and Ten pivot around the 1997 Wallis inquiry. The economic crisis of the early 1990s shaped the politics of banking for a decade, characterised by the re-emergence of anti-bank populism. The consumer’s experience with banks became a central political issue in the 1990s in a way that it had not been since the 1934 election. In this context the thesis looks at the prudential significance of bank mergers and the ‘Four Pillars’ policy as it was seen before and after the Wallis inquiry. Chapter Ten looks at the development of the idea that public policy should ensure that bank deposits are a “safe haven” for depositors’ funds, and its significance for the re-establishment of the bank deposit guarantee under the Rudd government in 2008. While the Wallis inquiry had argued the case for market discipline in banking it also maintained that bank deposits should be risk-free. By looking at the trajectory of events from the financial crisis and recession of the 1990s to the 2008 global financial crisis, we can see how the contradictions in that position ultimately led to what the Campbell committee and Wallis inquiry had
explicitly rejected: a Commonwealth bank deposit guarantee. Finally, the Conclusion summarises the main findings of this thesis, and discusses some opportunities for future research.

1.6 Thesis boundaries
It is necessary at the outset to clarify what this thesis does not intend to do. First, it does not propose to account for the economic consequences of financial regulation insofar as those regulations affect welfare. Such analyses form the foundation of many of the inquiries introduced in the following pages. The economic and political consequences of financial regulation are of interest to the extent that they shape the pressures for regulatory change. As the next chapter will explore, whether regulatory change is driven by the possibility of Pareto-improving reform is one of the central questions of the thesis itself. Second, and relatedly, it does not propose to draw judgment on the desirability of regulatory change. It seeks a positive explanation for reform rather than a normative assessment of any given regulatory framework. However, positive accounts should guide normative claims. Only by understanding why regulatory change occurs – and the economic and political factors which drive it – can societies develop constitutional level constraints on political action.

1.7 Findings
The history of Australian prudential regulation can be divided into three periods. In the first period, which lasted until the Second World War, there were few prudential controls on Australian banks and prudential standards were imposed by market discipline. The creation of the Commonwealth Bank in 1911 made little difference to this regime, as it was designed as a competitor to, rather than regulator of, the private banks. While its widespread description as a central bank did imply some sort of lender of last resort function, this function was both ambiguous and untested. The second period lasted from the introduction of the Banking Act in 1945 and the introduction of foreign banks to Australia in 1985. During this period of financial repression, prudential controls were extensive and severe. The third
period is often described as ‘deregulation’ (Kelly 1992). However, in the area of prudential regulation it is better described as the *formalisation, standardisation, and internationalisation* of regulation. The Australian system of prudential regulation was more extensive after the economic reforms of the 1980s than it was before.

What drove these changes? I find that shifts in regulatory regime can be explained by changes in perceptions about the dictatorship and disorder costs of institutions. The subjective political economy approach outlined in Chapter 2 views the public interest concerns, private interest concerns, and ideological concerns of individual policymakers through the prism of perceived costs. The framework allows me to analyse long run shifts in ideas about the nature of banking and the purpose of regulation within an economic framework, as well as integrate institutional innovation into the dynamic of change. Applying this framework, the thesis finds the change from a *laissez faire* prudential regime before the Second World War to financial repression after the war was driven by the ideological legacy of the bank crashes of 1893 and new ideas about the role of the state as an agent of economic control. Reforms to prudential regulation on banks from during the 1980s were driven by the perceived disorder costs of limited prudential regulation on building societies during the 1970s, and the institutional pressures on the RBA’s informal regulatory approach with the introduction of foreign banks. Since the 1990s Australian prudential regulation has been shaped by the institutional demands of internationalisation and ideas about the government’s special responsibilities for small depositors established more than a century earlier.

Finally, I also identify how the justifications for many specific regulatory interventions have shifted over time. Throughout the thesis, certain controls – such as those over ownership, mergers, or requirements to hold accounts at the central bank – have been rationalised according to the regulatory theories of the
day, rather than reconceived. This suggests a form of institutional stickiness, where regulatory
institutions survive the expiration of the ideas which first inspired their creation, and a feedback
mechanism whereby the existence of an institution affects ideas about the costs of dictatorship and
disorder. The significance of these findings will be explored and elaborated in the Conclusion.
2 WHY ARE BANKS REGULATED? A SUBJECTIVE POLITICAL ECONOMY APPROACH

2.1 Introduction

For as long as banks have existed they have been subject to state controls (Grossman 2010). If we consider prohibitions on usury to be the first primitive banking regulation then banking regulation dates back at least to Hammurabi’s code in 1760 BCE (Geisst 2013). This chapter looks at the dominant political economy models that explain why societies impose prudential regulation on banks, creating a framework through which later chapters can understand why prudential regulation was imposed on Australian banks between 1893 and 2008.

It does so by introducing two frames through which political economy can be studied. Addressing my first research question as to how to characterise regulatory change over the period studied by my thesis, the first half of this chapter looks at the comparative approach offered by Djankov et al. (2003). This approach seeks to first characterise and then explain divergence in strategies of economic control across sectors, time, and jurisdictions. Regulation by government regulators is one strategy on a continuum between “disorder”, represented by the laissez faire market, and “dictatorship”, represented by full state nationalisation. Societies need to choose the tradeoffs between these two extremes. The second half introduces models of political economy that explain that choice, offering a theoretical framework to consider my second research question. Derived from Kroszner (1999), these include the public interest explanation, a group of private interest explanations including the self-interest of firms and the self-interest of governments, and explanations based on ideas. In this, the function of ideas as determinants of regulatory change will become plain. The chapter concludes by introducing the ‘subjective political economy’ approach, a new framework for political economy analysis jointly developed with my colleague Darcy Allen and published as a working paper (Allen and Berg 2016), which brings together
these two approaches, thereby integrating the role of ideas in a theory of institutions and institutional change. This new approach helps address my third research question in turn, and offers a highly prospective new framework through which to see institutional change.

At the outset, it is important to note that the question of why regulation was imposed on banks is a different question from why societies ought to impose regulation on banks. The latter is a normative question and the former is a positive question, following the is - ought divide articulated by Hume ([1738] 2007). As Keynes (1986, p. 22) wrote, “The object of a positive science is the establishment of uniformities, of a normative science the determination of ideas, of an art the formulation of precepts”. Nevertheless, normative ideas of banking regulation come into the scope of this thesis insofar as those normative ideas effect the historical actors who lobby for and introduce regulation. Hume ([1738] 2007) counselled that an ought cannot be derived from an is. Normative ideals cannot be drawn from positive description. However, the normative-positive dichotomy is an unstable one (Davis 2013). Hands (2012) notes that ought can often explain or determine is. We shall consider this in the role of ideas in Part II of this chapter.

2.2 The Institutional Possibility Frontier

The first frame through which regulatory change must be analysed concerns the characterisation of any given regulatory order. One of the central themes in the literature on Australian banking policy is the changes in the extent of regulatory control (Maddock 2013; Schedvin 1992; Thomson and Abbott 2000). However these characterisations lack a theoretical framework through which those regulatory orders can be compared. This thesis adopts an institutional approach. Beginning in earnest with Coase (1960), institutional analyses focus on the institutional arrangements and transactions costs that influence or determine the incentives faced by economic and political actors (Greif 2005; Hayek [1960] 2011; North 1981, 1990a, 1990b, 1999; North and Weingast 1989; Olson 1965, 1982; Ostrom 1990).
Shleifer (2005) and Djankov et al. (2003) offer an institutional theory of regulatory choice. They start by assuming that “society” wants to control the activity of a private firm and consider the institutional options available to do so. Society could rely on social or market discipline to control the firm. A more direct form of control would be control through private litigation. More direct control again would be enforcement through state regulation, and finally at the extreme would be state ownership of the firm. Each of these alternatives do not represent distinct strategies but points along a spectrum of control. Each involve costs and trade-offs. “The two central dangers that any society faces are disorder and dictatorship” (Djankov et al. 2003, p. 598). Disorder is a danger where social control is least, and is intended to describe everything from physical violence to monopoly pricing. For example, the disorder risk in banking might constitute reckless lending, deceptive financial products, and theft of depositors’ funds. Alternatively, dictatorship brings costs in the danger of expropriation by the state, taxation, violation of property rights, and the use of state resources and coercive power for private gain. In banking, these risks might constitute forced loans to the state, expropriation via reserve requirements and captured markets for government securities, the creation of barriers to entry in banking which favour private interests, and outright government theft of deposits.

The purpose of institutional control is to protect society against the twin dangers of disorder and dictatorship, but as Djankov et al. (2003) point out, such protection can only be imperfect. Complete market discipline protects against dictatorship but can risk disorder, and complete public ownership protects against disorder but can risk dictatorship. That spectrum of control is modelled along the institutional possibility frontier (IPF), depicted in Figure 1. Dictatorship costs are shown on the x-axis and disorder costs shown on the y-axis. The intersection between the IPF and the 45 degree downward slope in the figure represents the efficient institutional choice, where the social costs from dictatorship and disorder are minimised.
Figure 1: The Institutional Possibility Frontier

In the figure, the efficient institutional choice is positioned between independent judges - that is private litigation - and the regulatory state. However, “[t]he location and the shape of the IPF, and hence the efficient choice, are determined by a number of factors” (Djankov et al. 2003, p. 600). Accounting for these differences involves considerations of the nature of the economic activity for which control is sought - for example, the homogeneity of the good or service, of the customers, the technologies involved and efficacy of reputation mechanisms - as well as the broader institutional context in which control is being imposed. “Civic capital” is stronger in some societies than others, in a sense which encompasses both the social capital made famous by Putnam (2000) but also resource and factor endowments, ethnic homogeneity, available technologies, human capital and so forth. Civic capital effects the shape of the IPF. For example, low levels of civic capital increase the costs of disorder.
Technological change might make the possibility of private or state expropriation more salient. Similarly, the points on which certain institutional choices rest on the IPF will vary according to a range of factors. A weak rule of law would increase the disorder costs of a private litigation strategy. The IPF has been applied to a number of policy settlements. Berg and Davidson (2015) consider the IPF for regulation of print and broadcast media. Davidson and Potts (2016a, 2016b) look at an institutional approach for innovation policy. Other areas that this approach has been usefully applied are productivity (Davidson 2013), the environment (Davidson 2014), and tobacco control (Davidson 2016).

Djankov et al. (2003) note that the location and shape of the IPF is fixed in the short run. However, in a historical context the location and shape of the IPF changes, influenced by changes in social capital, technology, the institutional and economic constraints, and, as we shall see, subjective individual perceptions of the risks of disorder and dictatorship. The possible locations of the IPF are also constrained by historical factors. Prior institutional choices constrain and direct future institutional choices. Glaeser and Shleifer (2002) and La Porta et al. (2007) look at the economic significance of legal traditions - what they describe as Legal Origins Theory - as those traditions are transplanted through colonisation or conquest. While there is much divergence in legal and regulatory systems, colonial or imperial origins have shaped ideas about the purpose of the law in societies in important ways. Countries that have inherited or had imposed on them English common law have fundamental differences in levels of state control – that is, they choose control strategies on the IPF more tolerant to disorder - to those who have inherited or had imposed on them the French civil law tradition.

Institutional analyses emphasise path dependency (David 1994). Social, political, economic and legal forms develop within certain institutional contexts, which in turn act as interests that help determine future institutional change. Greif (1993, 2006), Kuran (2011, 2012) and Gelderblom (2013) consider the
legacy of medieval commercial institutions on long run development. North and Weingast (1989) consider the significance of the 1688 Glorious Revolution constitutional compact which allowed the government to credibility commit to a regime of property rights, an institutional change which foreshadowed Britain’s lead in the Industrial Revolution. Congleton (2011) has studied institutional bargaining in the establishment of representative government and the expansion of suffrage. How to establish credible commitment – not just from governments but all actors – is one of the most important questions in economic and political development; an observation which Coyne (2008) applies to the challenge of establishing liberal democracy in foreign countries.

There is a recognised tension in Djankov et al. (2003) between their explanation that societies choose the efficient control strategy on the IPF - that is, the strategy that minimises the cost of disorder and dictatorship given certain levels of civic capital, characteristics of the economic activity to be controlled and so forth - and that legal origins explains why some societies choose certain strategies over others. This is particularly the case in light of their work that common law countries benefit from greater judicial independence and constitutional review (La Porta et al. 2004) and lower levels of procedural formalism (Djankov 2003b). Path dependencies can prevent societies from making efficient choices. In this sense, it is useful to recast the well-known theory of institutional sclerosis of Olson (1982) through the IPF framework. The rent-seeking and interest group formation enabled by disorder and dictatorship costs limits institutional adjustment when the IPF changes shape or location. The Djankov et al. (2003) model provides a useful model for characterising and then comparing strategies of control but lacks analytical power to explain why strategies are chosen. A normative claim about where the efficient point on the IPF lies does not mean that society’s choice of control strategy is efficient. In the next section, therefore, I consider alternative explanations for regulatory choice and regulatory change.
2.3 Using models to explain regulatory choice

Why do societies choose certain control strategies on the IPF? Explanations for the existence of regulatory forms vary immensely. Public choice scholars have contrasted two forms of positive political economy as the “public interest” and “private interest” or public choice model. The seminal work by Buchanan and Tullock ([1962] 1999) described this division at the level of democratic consent. In the context of banking regulation, Barth et al. (2006) and Grossman (2010) contrast publicly interested regulation with regulation driven by the private interests of regulators and regulated entities. One example of such reasoning applied to Australian banking history is provided by Harper (1985), who looked at the Campbell committee report and financial deregulation in the 1980s.

However, the two model approach is inadequate because it fails to account for, and adequately distinguish between, a host of potential and important influences on policy change. By focusing on material interests, it neglects the role of ideas and ideology (Rodrik 2014). It also understates and obscures the diversity of the interests which may influence public policy. As Black (2002) points out, the regulatory state is a diverse network of actors, which include executive governments, independent regulators, firms, and non-profit lobby groups. Furthermore, state-centric interests - such as the interests of bureaucracies (Niskanen 1971, 2008; Parkinson 1957; Von Mises 1944) - ought to be clearly distinguished from non-state interests.

A richer variety of explanations for the existence of certain regulatory forms in banking is offered by Kroszner (1999), who distinguishes between explanations on based on theories about the public interest, the private interest, Leviathan, ideology, and institutions. This framework delineated in this section is an adaptation of that typology. I consider the self-interest of firms, regulators and elected representatives separately under a general category of private interest. Kroszner’s ‘institutions’ explanation fits the institutional analysis offered above, but offers little as a positive explanation for
institutional choices. A society that chooses the most efficient point on the IPF can be described as adhering to a public interest model of regulatory choice. Deviations from that point need to be explained. Likewise, explanations that rely on path dependencies need to explain the original choices that underpin those paths. For example, Australian institutions might inherit the legacy of British constitutionalism or may have been determined by the country’s roots as a penal colony, but the original decision to colonise Australia still requires explanation. Path dependency explains trajectories but does not provide causes. Hence we need to look at the influence of interests and ideas.

2.4 Public interest models
The public interest is the normative ideal of collective political action in a liberal democracy. This normative model has a strong moral and rhetorical hold. Bureaucrats self-describe as the “public service”, or as “public servants” (Levine and Forrence 1990). However, the phrase “public interest” conceals a great deal of conceptual complexity. What constitutes the public’s interests, as opposed to the interests of specified individuals? A domain can be seen as public if it “has no immediate relation to any specified person or persons, but may directly concern any member or members of the community, without distinction” (Lewis 1832, p. 233). Barry (1965, p. 190) offers a normative definition of the public interest as “those interests which people have in common qua members of the public,” drawing a distinction between policies which are beneficial to the public on net, and those that are beneficial to the public as a group. One way to see this reasoning is through the Rawlsian veil of ignorance, in which public interests are what the public would agree on before initial positions are assigned. However, such careful judgment of what constitutes publicly interested motivated policy may be excessively fine. In a critique of private interest explanations for policy, Mikva (1988) offers a usefully simple definition of public interest policy as that which is “fashioned by people ... who are thinking of the public interest (as they see it)” (p. 173).
2.4.1 Regulation in the public interest

There are many public interest arguments for government regulation of economic activity. Pigou (1932) argued that government intervention is justified in circumstances where markets, left to their own devices, would operate sub-optimally or result in suboptimal outcomes. Under a *laissez faire* regime, private costs and social costs often diverge. In any economy that has imperfect information or incomplete markets there exist government interventions which could improve welfare (Atkinson and Stiglitz 1980; Greenwald and Stiglitz 1986). The usual benchmark for welfare improvement is the Pareto criterion, in which desirable change is that which makes some people better off while making no one worse off. Under the search for Pareto optimality economists advise that governments should intervene in markets in order to mitigate or resolve market failures (Acemoglu and Robinson 2013).

What market failures exist in financial markets? Stiglitz (1994) considers that financial markets are particularly susceptible to failure through information inefficiency. Information is a public good and will not be adequately provided in a competitive market. Credit institutions face information asymmetries as to the credit-worthiness of their customers. This leads to adverse selection as those with the riskiest credit prospects will tend to seek more credit, with the ultimate result being credit rationing (Stiglitz and Weiss 1981). Information asymmetries in banking contracts travel both directions. Banks find it hard to assess the creditworthiness of their borrowers, and depositors find it hard to assess the prudential condition of their bank (De Ceuster and Masschelein 2003). The classic transmission of the information asymmetry problem to financial instability is through bank panics and bank runs. Such crises occur when depositors withdraw their money from banks under the assumption that their bank faces a solvency problem. Unexpected withdrawals can create acute liquidity problems. Bank runs are self-reinforcing. In the absence of information about the condition of their bank, depositors who see other depositors withdraw their funds are likely to do the same. Without information specific to a single bank, these runs
on one bank can spill over to other banks (Barth, Caprio and Levine 2006). Through these and other mechanisms Gertler (1988) and Mishkin (1990) place information asymmetries at the centre of the waves of financial crises that have gripped the United States economy.

Information asymmetries are not the only potential cause of financial instability. Market failure explanations for banking instability contrast with those that see instability as a reflection of real economic change. For instance, Fisher (1911) explains bank runs as the result of interest changes leading to the failure of bank loans. The resulting collapse of bank credit causes more business failures, exacerbating economy-wide economic crises. In the Diamond and Dybvig (1983) model, bank instability is caused by preference shocks. Banks exist in order to share risk among depositors who have random needs for consumption. However, due to random changes in depositor expectation about the viability of the bank, they are vulnerable to an equilibrium where all depositors seek to withdraw their funds as quickly as possible. Bank runs can be seen as a sort of prisoners’ dilemma game where the relevant depositors’ expectations concern the expectations of other depositors, rather than the stability of the bank itself (Postlewaite and Vives 1987). In these models, “banks resolve one market failure while creating another” (Byford and Davidson 2013, p. 418).

2.4.2 Prudential regulation in the public interest

The need to resolve these market failures in banking is one explanation for the observed existence of prudential regulation. In the terminology of the IPF, there exist a range of regulatory controls which might resolve the market failures and reduce the disorder costs which have been identified in financial markets. Rather than relying on competitive markets, governments might simply provide monitoring of financial firms. (A form of this hands-off approach was proposed by John Hewson when he was Commonwealth opposition leader: see Chapter 9). Further down the IPF, there are a wide range of more
coercive regulatory possibilities. Governments can and have imposed liquidity standards and capital requirements, imposed controls on loans to insiders, provided guarantees on depositors’ funds, placed restrictions on the type, volume and diversity of loans, offered lender of last resort facilities, controlled interest rates on deposits and loans, imposed fit and proper person tests of bank management, and controlled which investors would have priority in the case of a bank failure (a valuable survey of regulatory interventions is Barth, Caprio and Levine 2006). This is a necessarily incomplete list, and this thesis outlines the origins and evolution of many of those possible controls in the Australian context. Governments have also responded to banking panics in many ways. They have forcibly closed banks through the declaration of bank holidays, offered temporary or permanent guarantees to bank management, facilitated mergers with stronger banks, and declared bank notes legal tender. Each of these strategies can be seen as points along the IPF, shown in Figure 2, which represents a selection of institutions either implemented or proposed throughout the period of history in this thesis.

**Figure 2: Prudential Regulation on the Institutional Possibility Frontier**
In a market discipline control strategy, depositors and investors monitor on their own accord the performance of a bank and its management. Increased regulatory control involves regulatory supervision, the introduction of depositor preference over other investors, the suite of available regulatory controls, and then deposit guarantees. The acquisition of a bank by the central bank in the time of crisis is a form of state nationalisation. Full nationalisation was proposed by the Chifley government at the end of the Second World War. Figure 2 is a necessary simplification, as in fact societies choose a mixture of control strategies and institutional combinations along the IPF. For example, market discipline still plays a role, if a diminished one, even in a system with capital and liquidity requirements.

Each of these control strategies have disorder and dictatorship costs. Those costs are also variable dependent on the civic capital of any given jurisdiction. Market discipline is likely to have less disorder costs in a country with high levels of education and high technological capability - thus enabling investors to monitor bank activity more effectively - than one with low levels of education and low technology. Full nationalisation will have less dictatorship costs in a liberal democracy with freedom of the press and the rule of law than in a country which lacks those institutions.

2.4.3 Public interest as a positive model

In the public interest model of regulatory choice, societies choose the control strategy along the IPF that minimises disorder and dictatorship costs. In this way, the public interest model is a model of efficient institutional choice. However, this is a normative model rather than a positive one. It describes what governments ought to do, not necessarily what they actually do, and is usually used as a guide for policy rather than a description of the world. The economists who are most associated with the development of the market failure arguments for government intervention were very conscious that actually-existing
government regulation was not, in fact, institutionally efficient. The Cambridge welfare economists Henry Sidgwick, Alfred Marshall and A.C. Pigou all held ideas of government failure - albeit an underdeveloped one in comparison to later public choice scholars (Backhouse and Medema 2012).

Nevertheless, uses of the public interest model of regulation have not always rigidly enforced this distinction between normative and positive analysis. In what Hillman (1998, 2004) describes as “politically correct” economic analysis, the normative assumption of publicly-interested government is smuggled into descriptions of what governments actually do. “The censorship that is then implicitly imposed limits politically correct economic analysis to normative theory where government can do no wrong” (Hillman 2004, p. 137). Joskow and Noll (1981, p. 36) write that “the essence of this normative analysis as a positive theory is that one begins an analysis of a regulatory process with the assumption that its purpose is to maximize some universal measure of economic welfare, such as consumers’ surplus or total surplus”.

More explicit defences of a positive model of public interest regulation are founded on the motivations of decision makers to pursue their conception of the public interest (Green and Shapiro 1994; Lewin 1991; Udehn 1996). Tullock (1984), for example, provides a partial defence of the publicly interested motivations of voters. Voters might be charitable, or they might be asked to make decisions on policies in which they do not perceive any direct personal interest, and vote therefore according to their perception of the public interest. Kelman (1990, pp. 201-2) offers a defence of publicly interested politicians who seek office not only for the salary and privilege which office brings, but because of personal preferences to “formulat[e] good public policy” and “to do good”. Kelman notes that such public interest motivations are reinforced by bureaucratic subordinates who do not face re-election pressures and offer a countervailing pressure against the self-interested use of power.
As this suggests, there are two distinct interpretations of the public interest model of regulation which are often conflated. The first is the form of politically correct economic analysis defined by Hillman (1998, 2004), in which the fact that governments *ought* to maximise welfare through Pareto-efficient tax and regulatory policies is taken implicitly as a claim that governments *do* act in this way. Thus the observation that society has chosen a point on the IPF is taken as evidence for that point being the most efficient point given prevailing levels of civic capital and industry characteristics. The second interpretation more directly concerns the motivations of policy actors. In this, decision makers - voters, bureaucrats, politicians - are seeking *what they consider to be* the most efficient point on the IPF. In this second interpretation what matters is the knowledge and preferences of voters and decision makers about what constitutes the public interest. Thus from an analytical perspective the observation that society has chosen an inefficient point on the IPF is not necessarily a strike against the public interest model, rather it might be the consequence of a lack of knowledge of policy actors about the dictatorship or disorder costs of certain choices.

2.5 Private interest and the field of public choice
The most sustained and direct criticism of the public interest model of regulatory choice has come from the public choice school, which posits that political decision makers are self-interested and face incentives which select against efficient IPF choices. Public choice scholars begin their critique of the public interest story of regulation by arguing that where traditional economic analysis has modelled actors in the market as driven by self-interest, actors in government had been modelled as benevolent, publicly interested dictators. Hence Mueller (2003, pp. 1-2) writes that “man is an egoistic, rational, utility maximiser” and both sides of the public policy process - the market and the political system - need to be modelled with this postulate in mind. In the public interest model, economic regulation is imposed upon firms for the benefit of the community. In the public choice model (which this thesis will describe
as the “private interest model” for ease of reading and in order to avoid unnecessary terminological confusion) economic regulation is imposed for the benefit of one or more political actors. Public choice analysis has been applied to a wide variety of actors in the political system, with some strikingly different conclusions. Here I approach the manifestations of private interest through the influence of firms on the political system, the self-interest of political and bureaucratic actors, and finally the construction of political coalitions of self-interested actors.

2.5.1 Firms

Like traditional market failure theories of government interventions, the public choice literature models firms as self-interested profit maximising agents. Public choice differs from traditional public interest however insofar as it models those firms’ interactions with the political system. An early contribution to this literature by Bentley (1908) emphasised the role that interest groups play in the formation of public policy in a democracy, depicting democratic politics as a competition between these groups for influence over government activity. For Bentley the key relationship is not between state and industry but between interest groups for control of the monopoly coercive power of the state. The central contribution by Olson (1965) demonstrated the existence of a ‘market’ failure in the collective provision of public goods, as collective decision-making is vulnerable to capture by interest groups. Where voters as a collective have an incentive to prevent rent seeking by firms through the political process, the high cost of organisation and the diffuse benefits makes doing so prohibitive. Where benefits are concentrated in a few firms, those firms can justify the expenditure in lobbying and advocating for policies that might directly benefit them.

The private interest model of regulation predicts that a regulatory framework will deliver rents to private interests. Stigler (1971) argued that rather than having regulation imposed upon them, firms
acquire regulation for their own benefit. A simple example is occupational or industrial licensing that limits the number of potential competitors in a given industry, such as the restrictions on foreign bank entry which prevailed in Australia between 1945 and 1985. Cartel-like behaviour is more effective if it is backed by state regulation which prevents defections or entry. Thus Peltzman (1976) emphasises the importance of coalition building in the drive for privately-interested regulation. Posner (1974) argues that the demand for regulation will be greatest in industries where the prospect of privately-enforced cartelisation is lowest. In a market, economic rents tend to be driven down over time by competitive pressure. In a competitive market, entrepreneurs erode economic rents by finding new profit opportunities (Kirzner 1985). The observation that entry regulations suppress competition and entrepreneurism dates back at least as far as Adam Smith ([1776] 1976). Shughart II (2004) suggests that the existence of entry barriers into any industry should be seen as prima facie evidence of supranormal profits. Economic rents acquired through regulation or legislation tend to be fixed and monopolistic, which leads to socially wasteful rent above opportunity cost: thus the term “rent-seeking” to characterise firms that try to profit through manipulating the political system in their favour (Buchanan [1980] 1999).

Mitnick (1980) offers three reasons why, despite the normative strength of the public interest within bureaucracies and legislatures, regulation is nonetheless introduced in private interests. The obvious is that policymakers might be venal or corrupt. A less malevolent explanation is a “revolving door” between regulatory agencies and firms, where the prospect of later employment leads regulators to favour the interests of those firms when making decisions (Blanes i Vidal et al. 2010; Johnson 1989; Luechinger and Moser 2014). Alternatively, regulators might be incompetent and unable to identify when their actions benefit rather than restrain firms. Regulatory agencies and bureaucracies might pay below market wages for their roles, leading to a lower quality workforce. Political patronage may favour
less-qualified regulators to take senior roles. A further explanation is that private firms might exploit information asymmetries about their activity when interacting with regulators. Policy-makers typically have less information about the cost structure (Baron and Besanko 1984), demand function (Lewis and Sappington 1988), technological capacities (Sappington 1983), and quality (Pflum 2011) of a firm and its output than the firm itself. To the extent that those asymmetries exist, they give the opportunity for firms to control the flow of information to policy-makers or regulators in a way that suits the interest of the firm. Private actors govern the information and quantity of information provided to government and might strategically disclose only that information that would lead the government to regulate in their interests.

2.5.2 Bureaucratic interest, political interest and the interest of leviathan

Private interests need not be solely restricted to private sector actors. Those in charge of regulatory frameworks and policymaking have their own interests that may be distinct from the interests of the public or those who whose interests they are meant to serve. Politicians and bureaucrats are “like other men” (Tullock 2006, p. 61). They desire larger salaries, more job security, better reputations, nicer workplace amenities, greater flexibility to manage their affairs and budgets, more power and more influence (Niskanen 1971, 1973, 2008). Regulation and policy making more generally might be designed and implemented in order to deliver rents to those who design it. This is the leviathan model of private interest. Here I divide the leviathan model between the two general classes of government actor: bureaucrats or regulators (these terms are used indistinguishably for the purpose of this model) and elected political representatives. Each face different incentive structures.

An early contribution to the economic study of bureaucracies by Von Mises (1944) identified their key characteristic as the absence of market prices in decision making processes. Niskanen (1971) describes
the essential features of a bureaucracy: they typically have a monopoly buyer; are often a monopoly producer; are compensated with a budget for output, rather than on a per-unit basis; the bilateral monopoly relationship makes it impossible for the budget to determine a market price equilibrium, increasing the agency losses from information asymmetries between bureau (agent) and sponsor (principal); and finally, neither bureau or sponsor have a direct financial stake in the outcome. Bureaucratic agents are typically more informed about the machinery and operations of government than the legislature to which they are responsible (Niskanen 1971). Weber (1946, p. 232) observed that “[u]nder normal conditions, the power position of a fully developed bureaucracy is always overtowering. The ‘political master’ finds himself in the position of a ‘dilettante’ who stands opposite the ‘expert’, facing the trained official who stands within the management of administration”. The influence of bureaucratic interest on public policy formation has been emphasised most prominently by Wilson (1989). Attempts to resolve agency problems and reduce bureaucratic interest over public policy can lead to policy uncertainty (Bendor et al. 1987). One powerful tool the legislature has is final control over the bureau’s budget, which can be adjusted in anticipation of bureaucratic self-interest (Wildavsky 1984).

Constraints on bureaucratic discretion to pursue its self-interest cannot be absolute as the principle is not of one mind about the goals of the agent. In the bureaucratic drift model (Hammond and Knott 1996; Macey 1992; McCubbins et al. 1987; Shepsle 1992), public policy is formulated by coalitions of sponsors who have different preferences about how the bureaucracy should act. The coalition defines an ex ante policy space in which the bureaucracy can function, bounded by the preferences of its sponsors. Within that space, the bureaucracy will seek to pursue its own interests as much as possible while remaining within its statutory bounds - ‘drifting’ towards its own policy preference. This is a formalisation of what Kalt and Zupan (1984) described as agency ‘slack’. Further enhancing the
discretionary power of bureaus is the fact that sponsor coalitions are not stable – the sort of information asymmetries described by Weber mean that they can be influenced over time by the preferences of the bureau (see also Krause 1996).

Politicians enter the public choice world with Downs (1957), who began the study of political interest with a utility-maximising politician seeking power, prestige or income. Buchanan ([1975] 2000) describes these and similar desires as “political income”. Downs argued that politicians pursuing their own preferences will seek to maximise voter support. Barro (1973) however argued that self-interested behaviour in politicians does not automatically align with the desires of that politician’s constituents. There is a large literature on the topic of voting and political choice which began with Arrow (1951), Downs (1957), Buchanan and Tullock ([1962] 1999), and Tullock (2006). Rational ignorance and rational irrationality on the part of voters give politicians wide room to pursue interests that may not be those of voters (Caplan 2007).

A further aspect of the private interest model is one which models the state as a unitary body with agency. Such a ‘leviathan’ analysis abstracts away from the individual interests which make up the state, and sees the state as forming its own monolithic interest. Brennan and Buchanan (1980) defend this approach on both positive and normative grounds. First, because it is not necessarily a greater abstraction than the *homo economicus* model which, despite its unrepresentativeness of the human condition, has nevertheless demonstrated substantial explanatory power. Second, because it provides a guide for normative policy development – as they argue, while the butcher and baker may sometimes be motivated by benevolence, a social order that did not rely on producer benevolence is likely to be more comforting. In the case of Brennan and Buchanan (1980) the leviathan seeks to maximise revenue.
2.5.3 Public choice as positive description

Public choice seeks a positive analysis of how the world is (Tullock 2008). However, it will be observed that the private interest models explored above are highly stylised, and function as ‘ideal’ models of self-interested rational political and economic actors under given constraints. The question is how well private interest models explain historical regulatory institutions.

The variety of private interest models outlined above need not be mutually exclusive. Calomiris and Haber (2014) provide an institutional interpretation of the history of banking regulation around the world grounded in private interest models that they describe as the “game of bank bargains”. In their argument, banks need governments and governments need banks. Banks are necessarily reliant on governments for the protection of three sets of property rights: protection against appropriation of bank funds by government, protection against appropriation of minority shareholder and depositor funds by bank insiders, and protection against appropriation of bank insider, depositor and shareholder funds by borrowers who might renege on their loans. In exchange for this protection, governments typically extract rents from the banks. This is further exacerbated by the fact that governments are both in charge of regulating banks under a normative public interest model and simultaneously reliant on banks for funding public finance. The regulatory framework that prevails is the result of a strategic interaction between coalitions of self-interested banks and self-interested governments. As they write

The property-rights system that structures banking has not evolved in response to some efficiency criterion in an anonymous “market” for institutions. Rather it is the product of deals arranged and enforced within an existing set of political institutions and hammered out by coalitions of market participants and the group in control of the government. These deals are intended to improve the welfare of the members of the coalitions and of the group in control of the government, not of society at large (Calomiris and Haber 2014, p. 38).
Of the possible parties to the game of bank bargains, there are bank insiders, minority shareholders, taxpayer-depositors, taxpayer-non-depositors, debtors and the group in charge of the government. Not all will be represented in the coalition. The prevailing regulatory framework will be determined by the bargaining strength of the various parties under a given institutional order. Democratic and authoritarian governments will have divergent regulatory frameworks, because the incentive structures within these systems differs, and the range of possible coalitions varies. These coalitions can select against public interest prudential goals of stability in individual banks and in banking systems. Calomiris and Haber (2014) use their model of bank bargains to explain the fragility of banking systems under different institutional arrangements.

North (1990b) criticises public choice scholars for neglecting the importance of transactions costs in their models of politics. Interest-centric models of politics assume instrumental rationality; that is, they assume that actors “either have correct models by which to interpret the world around them or receive information feedback that will lead them to revise and correct their initially incorrect theories” (p. 356). Yet a ‘political market’ is a highly imperfect market. Information is costly and asymmetrical, the models which political actors use to interpret phenomena are subjective, and enforcement of agreement is challenging. Institutional explanations focus on the imperfections – the inefficiencies, agency problems, and transactions costs of political and regulatory systems and how those affect the incentives of political and economic actors. Thus a newer generation of public choice scholarship looks at the transaction costs involved in political decision-making. For example, Caplan (2007), Somin (2013), and Congleton (2001) look at the function of ignorance among voters on public policy issues (see also Berg 2015b). In these models, voters are “rationally ignorant” or “rationally irrational” - the high cost of knowledge acquisition and the low probability of influencing an election with a single vote (Mulligan and Hunter 2003) means that a self-interested maximising voter will not invest the time to draw correct conclusions about the
consequences of their policy preferences. Rather than voting instrumentally, many voters use the ballot box as a vehicle for personal expression (Brennan and Lomasky 1993; Schuessler 2000). Thus models of self-interest can explain apparently ‘irrational’ observed levels of political knowledge in democratic countries (McAllister 1998).

A further challenge to public choice models founded in rational self-interest comes from the literature on behavioural economics, which studies the biases and cognitive errors that confound self-interested economic decision-making. Behavioural economics seeks a positive explanation for observed decision-making by providing economics “with more psychologically plausible foundations” (Angner and Loewenstein 2012, p. 642). Behavioural economics presents a challenge to economic models that are founded on self-interest and utility maximisation (Kahneman 2013; Kahneman et al. 1982; Kahneman and Tversky 2000; Rabin 1998; Simon 1986; Thaler 1991, 2015; Thaler and Sunstein 2008). The bulk of this work has gone into explaining the behaviour of participants in market transactions. However, the integration of psychology and economics can be applied to the study of non-market decision making through the political process. Some early work in this direction has emphasised the significance of cognitive errors and bounded rationality for regulatory behaviour (Tasic 2011). This direction of study is both a rich and underdeveloped direction for political economy, although it recalls the earlier, informal models of policymaker behaviour expounded by classical economists like Smith ([1776] 1976) and Mill (1848).

A related extension of public choice theory is provided by attempts to recast private interest models in the light of the Austrian economics challenge to rational choice theory (Boettke et al. 2007; Boettke and Lopez 2002; Evans 2014; Ikeda 2003). Following Hayek (1945, 1974), Austrian economics places knowledge rather than incentives at the centre of its analysis. As Boettke and Lopez (2002, p. 112)
argue, the public choice school challenged the assumption that policy makers were benevolent, but failed to challenge the assumption that policymakers were omniscient. Sutter (2002) draws a closer connection between the public choice school and Austrian economics, but nevertheless distinguishes between two conceptions of private interest and government failure determined by competing models of equilibrium and disequilibrium. The question is whether political bargains have a tendency towards equilibrium and how quickly they move towards it. An Austrian approach would emphasise the role of political entrepreneurs in determining the shape and form of the IPF (see Benson 2002; López 2002), reject notions of a statically efficient point on the IPF, and emphasise the knowledge barriers to efficient institutional choice. This challenge is met by the subjective political economy framework described below.

2.6 The economic function of ideas
Kroszner (1999) argues while interest-centred explanations help us understand why repressive financial regulation was instituted in the mid-twentieth century, they are less able to explain why the financial sector was substantially deregulated in the last decades of that century. A two-model construct of political economy – between public interest and private interest explanations – abstracts away from the role of ideas in forming political settlements (Hinich and Munger 1994). Hence typology of political economy models has to make room for ideas and “ideology” as an explanatory variable for institutional change. Ideology is a slippery concept, and often used as a simple pejorative (Eagleton 1991; Freeden 1996). One survey found 27 distinct definitions of the word ideology, from unverified or unverifiable statements to “a weapon in the class struggle” (Hamilton 1987). Ideology has both normative and positive aspects. It seeks to tell a story about the world as it is and how it should be. Downs (1957, p. 97) offers a purely normative definition of ideology as “a verbal image of the good society and the chief means of constructing such a society”. However, central to an individual’s worldview is a positive
description of the world as it is: one needs to have a critique of the current order to contrast with the image of the good society. Thus ideology incorporates “the mental frameworks – the languages, the concepts, categories, imagery of thought, and the systems of representation – which different classes and social groups deploy in order to make sense of, figure out and render intelligible the way society works” (Hall 1986, p. 29). As Rodrik (2014, p. 193) points out, political actors “believe they know how the world works, if not precisely, at least probabilistically”.

Ideas come into institutional analysis through the work of North (1990a, 1993b, 1993c, 1999), who argues that institutions consist of formal and informal rules (as well as enforcement mechanisms). Formal rules are those imposed by constitutions, legislation or regulation. Informal rules constitute norms of behaviour, conventions, and self-imposed rules of conduct. However, McCloskey (2010, 2015) argues that the emphasis on informal rules is too often used as a black box - “culture” - to explain empirical results which do not fit more traditional economic explanations. As an alternative, she, along with Smith (2012), calls for economists to pay more attention to “ideas, rhetoric, ideology, ceremonies, metaphors, stories, and the like” (McCloskey 2015, p. 14) that influence and direct human behaviour within a given institutional framework. These are in fact what Denzau and North (1994) describe as “shared mental models”, and North (1993a) identifies the possibility of multiple positive ideas - ideologies - coexisting that might explain empirical reality, leading to multiple ideological equilibria (see also Nye 2014).

Rodrik (2014) offers a similar critique to McCloskey of rational choice models that is nevertheless worth considering separately. In his view, private interest models of political economy fail to consider the role ideas play in the formation of the goals of individual economic agents. In rational choice models of political economy, agents seek to maximise their utility given their preferences, the constraints they
face, and the available choices in which they can act. However, ideas play a part in shaping each of these. Preferences need not be directed towards profits or consumer surplus. While profit-maximisation might be a valuable simplifying assumption in the economic sphere, it is less obviously valuable in the political sphere where “depending on context, honor, glory, reputation, respect, income, power, durability in office, and ‘good of the country’ are all plausible” maximands (Rodrik 2014, p. 191). It is recognised that preferences are subjective but as Hausman (2012) notes, economics cannot treat preferences as a black box, and preference formation ought to be subject to rational scrutiny.

The models of political economy outlined above - public interest, private interest and ideas - are not mutually exclusive. While public interest and private interest models are often counterposed in the public choice literature, both are themselves functions of the prevailing norms, ideologies, and cultures of firms, policymakers and voters. For example, ideas are determinative of public interest regulation. Barth, Caprio and Levine (2006) point out that the social efficiency implied by a public interest argument for banking regulation does not necessarily mean Pareto efficiency. Rather, “national tastes determine the degree to which the specific focus is on output maximization, variance minimization, or broadening access to capital” (p. 19). Even within the constraints of a public interest explanation this leaves a vast scope of unexplained variety in possible regulatory approaches. If “national tastes” have explanatory power, then some account of their origins and function is necessary in any positive analysis.

Similarly, any argument that regulatory changes have been introduced in accordance with the public interest model of regulation needs to come to terms with the fact that what is seen as in the public interest has changed over time. To take an obvious example, a model of public interest that focuses on Pareto-optimality cannot predate the publication of Pareto ([1906] 1971). Nor can we expect policymakers in the 1890s or 1930s to view the risks inherent in banking through the window of
Diamond and Dybvig (1983). Indeed, the division between “public interest” and “private interest” is itself a moving line. The utilitarian idea of each individual’s preferences being weighted equally in public policy formulation is an idea that can be traced historically, as Peart and Levy (2005, 2008) and Levy (2001) have shown. Formal definitions therefore of what constitutes publicly interested regulation such as provided by Barry (1965) are too fine to use for positive analysis. Rather scholars need to assess regulatory change according to the standards of its own era. Further complicating any attribution to a public interest model are lags in transmission of ideas from theory and scholarship to the domain of policymakers. This is what Keynes (1936, p. 383) was referring to when he wrote that “Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.” In this sense, public interest is in part a function of ideas; the scope and content of publicly interested change is determined and constrained by the ideas available to policymakers and advocates.

Likewise, what constitutes private interest is also partly a function of ideas. It is a reasonable simplifying assumption for most economic analysis that firms are interested in profit maximisation and the accumulation of financial rents. However, a firm might also be driven by a desire to be a good corporate citizen or to be a vehicle for a celebrity chief executive officer. The relationship between these goals and profit maximising is not always linear, and in large part depends on the perception of those who set the firm’s direction. Likewise, the self-interest of politicians and bureaucrats might manifest in diverse ways. Political rents can be acquired through power, influence, or celebrity. Bureaucrats might seek to maximise their discretionary budgets or the power and influence of their agency. Voters might vote in their financial self-interest or use their vote as a form of consumption, as predicted by the expressive voting literature. Voters indulge policy preferences which might be counter to their interests in the knowledge their vote is unlikely to be pivotal. A political system dominated by expressive rather than
instrumental voting will create incentives for purely self-interested politicians to cater to those expressive preferences.

2.7 Subjective political economy
In order to square this circle, in Allen and Berg (2016) we offer an integration of the function of ideas and interests within the institutional possibility frontier of Djankov et al. (2003). The resulting framework, which we call subjective political economy, is a highly adaptable and flexible framework through which to see the influence of ideas on institutional choice over time, as well as a number of important political dynamics, such as institutional disagreement and bargaining, coalitions, and institutional innovation – all of which are manifest in the history of prudential policy outlined in this thesis. Our integration also responds to criticisms of the IPF that the notion of institutional cost-minimisation is vague and that it fails to account for observed institutional differences between countries such as North and South Korea (Rosser Jr and Rosser 2008). Furthermore, the subjective political economy approach is able to resolve the tension between legal origins theory, with its emphasis on path dependencies leading relatively inefficient institutional choice, and the IPF framework where societies move towards efficient institutions over time. This section provides an outline of that framework, but this outline is limited to the features of the framework that offer a useful explanatory approach within the scope and length limitations of a doctoral thesis. More features of the framework and possibilities for the application of subjective political economy are outlined in Allen and Berg (2016).

Subjective political economy is based on two observations about the IPF. First, costs are subjective. Cost “exists in the mind of the decision maker and no-where else” (Buchanan 1979). What constitutes a dictatorship and disorder cost is a function of an individual’s subjective preferences. Second, the IPF as conceived by Djankov et al. (2003) is an aggregated, society-wide curve. However, each policy agent – voter, rent-seeker, business manager, politician, and regulator – will have their own individual IPF,
determined by their subjective understanding of dictatorship and disorder costs. Rather than talking about the institutional possibility frontier, we talk instead about subjective institutional possibility frontiers. What Djankov et al. (2003) observe as a single curve is in fact the product of many curves mediated by the influence of individual agents over institutional choice.

2.7.1 Subjective costs

There are many reasons why agents’ subjective costs might differ or change over time. They may have different individual preferences about the costs of dictatorship and disorder. This could be as simple as an aesthetic preference for order or disarray. Haidt (2012) argues that political ideologies are underpinned by a set of six moral foundations and their opposites: care/harm, fairness/cheating, liberty/oppression, loyalty/betrayal, authority/subversion, and sanctity/degradation. These differences can be seen as preferences for disorder or dictatorship and will help determine an agent’s subjective IPF. In the context of the prudential regulation of banks, preferences for risk will partly determine the perceived costs of regulatory institutions. Beck (1992) and Giddens (1999) trace the evolution of society-wide preferences about the way risks should be identified and managed.

Knowledge about the subjective costs of an institution can also vary. While an IPF is subjective to an individual agent, that agent perceives it as a positive depiction of the world. Agents assess real world institutional performance and that assessment informs their perception of the subjective costs of the institutional choices they face. Dramatic crises (such as the depressions and recessions studied in this thesis) or the collapse of large scale institutional arrangements (such as the fall of the Soviet Union) constitute new information about dictatorship and disorder costs. An individual’s subjective IPF will vary according to the lessons they draw from those events. For example, Posner (2010) concluded after observing the events that led to the GFC that he had been wrong to support the deregulation of the
banking sector. In the terms of subjective political economy, his perceived costs of disorder increased as he learned new information about the institution of deregulated banking, changing the shape of his subjective IPF. Intellectual advances also explain variations and change in subjective IPFs. For example, new academic literature, to the extent that it convinces political agents, might make certain institutional choices seem more costly than they otherwise did before publication. The sustained disequilibrium posited in Keynes (1936) can be seen as increasing knowledge about the disorder costs of the free market in employment and production. The publication and dissemination of Diamond and Dybvig (1983) increased knowledge and therefore subjective disorder costs of laissez faire banking.

We can explore the function of ideas and the IPF using the models of political economy outlined in this chapter. Consider for example the influence of the public choice school of thought, which Brett (2003) argues gave Australian policymakers a frame through which they saw the role and function of government and interest groups in the 1980s and 1990s. A voter who seeks to maximise social welfare with their vote who nevertheless believes that bureaucratic and political actors are motivated by self-interest would have a different subjective IPF to a voter who believed that policymakers are motivated by public interest considerations. All else being equal, the former will perceive higher dictatorship costs from state control than the latter.
Figure 3: Perceived prudential institutional possibility frontier for an agent informed by public interest models

Figure 4: Perceived prudential institutional possibility frontier for an agent informed by private interest models

Figure 3 depicts the prudential IPF as perceived by an agent who holds to a public interest model of regulatory choice. In this figure, the IPF has compressed to the left, reflecting the reduced perceived
costs of dictatorship. The agent is likely to favour an institutional choice with greater state control.

Figure 4 by contrast depicts the prudential IPF as perceived by an agent who believes that markets are relatively benign and is likely to favour institutional choices that rely on market discipline.

2.7.2 Disaggregated curves

Hayek (1945) argued that aggregate measures of economic phenomena remove the detail necessary to understand that phenomena. In Djankov et al. (2003) the IPF is an aggregate, society-wide depiction of institutional choice. In our analysis that IPF is an aggregation of the subjective IPFs, mediated by their influence over “society’s” choice of institution. Almudi et al. (2015) describe civilisation as the result of a contest between competing utopian visions. Consider for example a stylised society made up of two individuals, a pro-market agent and an anti-market agent, with equal political power and a fully-formed subjective IPF representing their different beliefs. Each conceive of the cost minimising institution as market ordering and nationalisation respectively. Figure 5 shows their two subjective IPFs and shows that the result of their bargaining is the regulatory state. In this figure we can see that what Djankov et al. (2003) show to be the cost-minimising position is in fact a compromise position chosen as a function of differing subjective costs and need not have any relationship to “real” or objective dictatorship and disorder costs. Djankov et al. (2003) imply that societies move towards a cost-minimisation point. However as Figure 5 shows the cost minimising point is a function of a diverse range of subjective IPFs, and is not objective ex ante.
Neither the pro-market agent nor the anti-market agent are completely happy with the institutional compromise, seeing the regulatory state as imposing more costs than their preferred institution. Their dissatisfaction can be shown as the distance between the cost-minimisation lines that represents their view of the most efficient institution, and the 45-degree line that intersects the regulatory state, that represents the costs of the chosen institution. The greater the distance, the more inefficient they perceive the compromise position to be. In this highly stylised example, market ordering and nationalisation are equidistant from the regulatory state, and both the pro-market agent and the anti-market agent are equally dissatisfied with the compromise position. Relaxing these assumptions gives us a more nuanced depiction of political disagreement and enhances the model’s explanatory power.

Likewise, imperfect bargaining results in an institution being chosen that is further from the compromise intersection. In a two agent political system where the anti-market agent holds all the political power,
nationalisation will be the chosen institution. The pro-market agent will perceive this as substantial inefficiency.

2.7.3 Institutional innovation

The final feature of subjective political economy relevant to this thesis is its description of institutional innovation. The IPF is a frontier of institutional possibilities. It does not represent a complete set of all possible institutions. Likewise, there are also positions on the IPF which do not have corresponding institutions. The IPF is not a continuous set. Figure 1 shows this implicitly by placing the cost-minimisation curve at a half-way point between independent judges and regulatory state. Under such circumstances, what institution does society choose? Likewise, in Figure 5, the point of intersection between the pro-market agent’s subjective IPF and the anti-market agent’s subjective IPF might not have a corresponding institution. The prevailing institution (under the assumption of equal political power) will be that which is closest to the intersection. To the extent that the chosen institution is not equidistant from the intersection, one agent will perceive higher subjective costs than the other agent.

Missing institutions along the subjective IPF offer the possibility of institutional innovation. The choice of institutions is not fixed. New forms of social control can be invented or adapted through intellectual and ideological endeavour. Faced with the disorder costs of a free market in money and the dictatorship costs of monetary policy directed by self-interested politicians, the doctrine of central bank independence was developed as a compromise position between the two. Keynesian interventionism was an institutional innovation between market capitalism and state ownership. We see a number of examples of institutional innovation sparked by changes in costs throughout this thesis. Preferences do not evolve uniformly among all agents. While the anti-market agent may be convinced that the Great Depression was an example of disorder costs, the pro-market agent may believe otherwise. In a dynamic
system unequally shifting curves provide incentives for dissatisfied agents to develop new institutions. Inventing and adopting institutions closer to the compromise intersection are more likely to prevent agents from rejecting the constitutional order.

2.7 Conclusion
Determining what model of political economy applies to a given historical situation is a non-trivial task. Pincus (2014, p. 2) notes that “It is a risky business to attempt to trace the influence of ideas on events”. Ideas are not transmitted linearly. Nor are ideas trump cards that override material interests. Other challenges are faced when trying to identify the underlying considerations behind policy decisions. For example, public interest justifications are often used as cover for privately interested regulation. Kroszner (1999, p. 4) points out that “private interests may try to confuse the public debate by providing false or misleading information to make it difficult to discern what policy would improve social welfare”. Ideas are formed endogenously (Tabellini 2015). As Hamilton (1987, pp. 24-5) writes, “there is likely to be a complex interplay between ‘ideational’ and ‘material’ forces”.

This chapter has outlined two theoretical frameworks that will be used throughout this thesis, and proposed a new framework of political economy which brings those two together. The IPF, which allows for the characterisation of regulatory institutions as a choice of trade-offs between disorder costs and dictatorship costs. The efficient institutional choice is that which minimises those costs. The shape of the curve is determined by the economic characteristics of the regulated entity, and civic capital - such as the strength of legal institutions, levels of social capital and trust - and so forth. It is also determined by the perceptions of the costs of dictatorship and disorder among political agents. Three models can be used to explain why society makes specific institutional choices. In the public interest model, society makes the efficient institutional choice on the IPF. The private interest model predicts inefficient institutional choice that delivers rents to economic or political agents. Ideas are presented as a third
distinct model to explain apparently inefficient institutional choice. However, the function of ideas can be reconceived as determining the shape of the IPF. This is integrated in the framework of subjective political economy, where the IPF is seen as a function of subjective costs perceived by individual political agents. Through the notion of subjective IPFs, we can show how bargaining results in observed institutional compromises and begin to identify a process by which political actors have incentives to develop new institutions. The next eight chapters will apply these frameworks to the history of prudential regulation in Australia, beginning with the financial crisis of 1893.
3 TWO DEPRESSIONS AND THE MONEY POWER: THE CRASH OF 1893 TO THE 1937 ROYAL COMMISSION ON MONETARY AND BANKING SYSTEMS

3.1 Introduction

This chapter traces the development of prudential banking regulation in Australia in the context of two major economic downturns: the Depression of the 1890s and the Great Depression of the 1930s. In 1893 the Australian banking sector experienced a serious crisis. Thirteen of the country’s 27 trading banks suspended payments. By contrast, the experience of the Australian banking sector during the Great Depression was much less traumatic. Indeed, the depression of the 1890s in Australia was deeper and longer than the depression four decades later (Fisher and Kent 1999). There were only three banking failures, and the cause of the largest of those failures, the Government Savings Bank of New South Wales, had political, rather than economic origins. Yet it was the Great Depression which led to the establishment of a system of prudential regulation and banking control. The 1937 Royal Commission into Monetary and Banking Systems recommended a substantial regulatory infrastructure which was brought into existence during the Second World War.

This chapter considers the political economy of regulatory change in banking as Australia moved from the nineteenth century system where social control was exercised by the market to a system where control was exercised through regulation. The chapter considers the models of political economy used in this thesis and concludes that the experience of the 1890s established an ideological link between the nascent labour movement and banking reform. Yet that relationship was non-linear in the decades after the banking crisis. The Labor Party did not immediately advocate policies that might have prevented the collapse of the banks, other than through its commitment to nationalisation. Only after the Great

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1 Parts of this chapter have been published as Chris Berg, 2015, 'The Curtin–Chifley Origins of the Australian Bank Deposit Guarantee', *Agenda*, vol. 22, no. 1, pp. 21-43.
Depression was policy proposed that would give the central bank regulatory responsibility for the private banks. Ideas about state control of banking took decades to coalesce into institutional change. Furthermore, those ideas which underpinned the regulatory framework during the Second World War were the result of an interplay between the labour movement’s ideas of banking and politics alongside those of the non-Labor parties and public sector agents such as the Treasury department.

The dramatic shift in regulatory approach between the \textit{laissez faire} nineteenth century and the post-war financial repression has been widely discussed (Butlin 1983; Giblin 1951; Schedvin 1992). However, the political economy elements behind this regulatory shift have been less well studied. This chapter first considers the banking failures of the 1890s in their institutional context and the reconstruction schemes which followed the suspensions. It then turns to the ideological consequences of that historical episode and the development of an antipodean idea of the ‘Money Power’ which governed labour movement conceptions of the social and political position of the banks. The Money Power provided an ideological frame for the Labor Party to understand the events of the Great Depression and the action of the Commonwealth Bank. It also informed the heterodox monetary and banking theories that flourished during this period. The 1937 Royal Commission reflected both this populist political context and an expert consensus for increased economic interventionism.

In this chapter and the next I focus on the public policy question of how the government should respond to a bank failure. The bank failures of the 1890s were the proximate cause of the development of the Money Power ideology that had such an influence on popular pressure for banking reform in the decades after Federation. The next chapter shows how the legacy of the crashes of 1893 was translated into policy in 1945. Yet despite its manifest importance, the resolution of bank failures in this period is an area which has received surprisingly little scholarly attention. Most scholarship on the interwar
period and Royal Commission covers in some depth macroeconomic policy and the growing influence of Keynesianism in the economics profession (Coleman et al. 2006; Maddock 2013; Markwell 2000; Millmow 2010; Schedvin 1973a, 1992; Turnell 1999). No doubt this is because there were few bank failures between the 1890s and the Second World War. However, this was the period in which perceived disorder costs of banking instability and the government’s responsibility towards depositors in failed banks was formed and translated into public policy. Later chapters in this thesis will show how ideas which developed in the prewar era are still with us today.

3.2 The financial terror of 1893

“France had her political terror in 1793 and Australia her financial terror in 1893”, reflected the banker George Meudell (1927). Blainey (1980, p. 331) characterised the crisis of 1893 as “the great scar in the nation’s history in that long period between the convict days and the massive casualties of the First World War”. The Australian bank panics were a manifestation of a depression which had been caused by a collapse in capital inflow from 1891 onwards. An Argentinian sovereign debt crisis had brought about the near insolvency of the London-based Baring Brothers and sparked economic turbulence throughout global capital markets (McLean 2006; Mitchener and Weidenmier 2008; Suter 1992). As well as Australia, Kindleberger (1985) connects the Argentinian problems to crises in New York, Rio de Janeiro, Santiago, Paris, Italy, South Africa and Berlin.

Australian banking in the second half of the nineteenth century is usually categorised as one of the major “free banking” episodes in economic history. Free banking describes the institutional setting where currency is provisioned by private firms in a competitive market (Dowd 1992; Hayek 1976; Selgin 1988; Selgin and White 1994; White 1984, 1989; Smith 1936). Rather than having monetary policy directed by a central bank, “a free banking system is subservient only to the forces of competition among the producers of monetary services attempting to meet consumers’ demands profitably” (White...
Limited supplies of English coin in the decades after Australia’s colonisation in 1788 meant that private promissory notes proliferated alongside barter and imported foreign coins (Butlin 1953). Vort-Ronald (1982) counts at least 59 separate banks or other organisations issuing currency in the period between settlement and the establishment of the Commonwealth Bank in 1911.

In the free banking period, Australian banks were relatively unencumbered by regulation. Owners were subject to double liability, and notes could only be issued on paid-up capital. Nevertheless, in practice these controls had little effect (Hickson and Turner 2004). Regulatory pronouncements were poorly implemented or ignored (Butlin 1953; Dowd 1993; Pope 1987; Turner 1904). There was little that could be described as prudential regulation. Calomiris (2006) explains the significance of Australia’s crisis of 1893 as constituting the “single exceptional case of a mature, relatively laissez-faire, nationwide branch-banking system that experienced a panic involving widespread bank suspension”. As such it has been a subject of great scholarly interest (Boehm 1971; Briones and Rockoff 2005; Calomiris 2011; Dowd 1992, 1993; Fisher and Kent 1999; Goodhart 1994; Hickson and Turner 2002, 2004; Merrett 1989, 1991, 1993a, 1993b, 2013; Pope 1989; Selgin 1992).

The extent to which the bank failures of 1893 were caused by lax prudential standards is a matter of controversy. Australian land banks and building societies had been failing since 1891 (Butlin 1961, p. 288). In late 1892 the trading banks faced a crisis as deposits and gold drained out of the banks. This crisis was all the more critical because their notes were fully convertible. The Commercial Bank of Melbourne suspended on April 1893, followed by another dozen banks geographically concentrated in Victoria and New South Wales (NSW). For those scholars who see the failure as a result of a market system tending towards recklessness, the failed banks had inadequate capital, excessively concentrated loan portfolios, insider loans, and had unsustainably expanded branch banking in response to the

There were few ex ante statutory provisions for bank resolution in the Australian colonies. Banks were regulated under general colonial companies law drawn from British companies acts or their own Charters or private incorporating acts (Merrett 2013; Waugh 1992). Under colonial joint stock company legislation, a minority of creditors had the right to force liquidation of a firm. With the financial system facing a drain on deposits in 1891 and 1892, both NSW and Victoria passed legislation to prevent such minority liquidation. In NSW the colonial parliament introduced the Joint Stock Companies’, Associations’ and Societies’ Arrangements Bill in December 1891. The legislation was modelled on similar legislation passed in England in 1870. Receiving assent in January 1892, the act provided that a majority of creditors holding three-quarters of the firm’s liabilities could come to a compromise with the firm that would be binding on a minority of creditors not a part to that arrangement. The Australasian Insurance and Banking Record was supportive of the legislation, depicting it as vital to ensure confidence (Boehm 1971). However, one newspaper correspondent objected that the upshot of this legislation was “the fact that a company is able to keep its doors open and carry on business will no longer furnish any presumptive evidence of its solvency” (Hay Standard, 23 December 1891, p. 2). In this sense the NSW legislation favoured management who were able to hold back forced liquidation by appealing to a majority arrangement. Foxall (1895) blamed the NSW act for extending the crisis and preventing the necessary market adjustments in land values, in order to protect bank debtors (in particular mortgagees).
Initial legislative reform in Victoria placed even more barriers to liquidation. The Voluntary Liquidation Act 1891 was designed to prevent ‘wreckers’ from forcing liquidation on firms which were solvent (Waugh 1992). The act required a third of creditors to consent before any liquidation could be order by a court. This requirement put such a high bar that compulsory liquidation “was practically suspended” in Victoria (Boehm 1971, p. 267). The requirement had the consequence of protecting bank directors (Butlin 1961, p. 286). The legislation was amended along NSW lines in December 1892 but in the meantime had the effect of badly damaging Victoria’s credit in Britain, exacerbating what was already a serious credit crunch in the wake of the Barings crisis.

These company law amendments set the stage for the reconstructions of the suspended banks. The Associated Banks of Victoria disavowed any of sort of binding mutual guarantee in March 1893, an announcement which has since been seen as the proximate cause of the next few months’ events (Butlin 1961; Coghlan 1918; Merrett 1993b; Sykes 1988). The proclamation of a sudden bank holiday in Victoria at the start of May also undermined confidence in the banks. The changes to liquidation law encouraged banks to suspend rather than to continue trading to ride out the panic, as a suspended bank would be able to take advantage of the potentially generous reconstruction arrangements. Reconstruction enabled the banks to recapitalise with the funds of their depositors, in a new bank under the same name, and defer repayment of deposits. Pope (1987, p. 29) writes that “[o]ne interpretation of the ‘crash’ of April-May 1893 is of a rush by banks to seize the vantage ground offered by reconstruction.” The Commercial Bank was able to attract deposits from other banks by re-establishing its business, just four days after suspension, ring-fenced from the old liabilities. Shareholder and depositor meetings were stacked to assure the new majority requirement for reconstruction plans (Sykes 1988, p. 183). Merrett (1993b), by contrast, argues that the reconstruction schemes forestalled a
deeper run on the banks. One contemporary observed that “every bank that broke completely ought to have done so. Indeed, some of them should not have been allowed to re-open” (Meudell 1929, p. 59).

Why did the Associated Banks of Victoria decide not to guarantee the deposits of its member banks? The Associated Banks had been formed in the 1850s as a result of the Victorian government’s railroad financing operations (Coghlan 1918, pp. Vol. 2, p. 839). Melbourne had the most developed banking sector, and there were no equivalent institutions in other colonies. In 1879 the association had undertaken to guarantee the note issue of the struggling Australian and European Bank and advance it money to reopen. But such action was neither binding nor allowed to establish a precedent. As the crisis of 1893 played out, public confidence was badly shaken by the Associated Banks’ apparently inconsistent approach to its obligations. On 14 March 1893 the Associated Banks announced they “agreed to act unitedly in tendering financial assistance to each other, such be required”. Yet the next day the Associated Banks clarified that such assistance would only be rendered “to such an extent as may seem justifiable to each of them” (Merrett 1993b, p. 126). Appearing in front of a Royal Commission in 1887, the General Manager of the English, Scottish and Australian Chartered Bank did not accept the Associated Banks had a responsibility to guarantee its members’ note issue (Royal Commission into Banking Laws 1887, p. 3). In a subsequent Royal Commission after the crisis, the General Manager of the Union Bank was interrogated as to why the banks declined to offer each other assistance, despite their apparent association.

But they were known as the Associated Banks? – So is the Chamber of Commerce and associated body; but no one supposes that one merchant would meet another merchant’s liabilities; that chamber might just as well be known as the associated merchants of Melbourne (Royal Commission on State Banking 1895, p. 269).
The Associated Banks were not associated to guarantee each other against failure, or the liabilities of each other against loss, as the *Australian Insurance and Banking Record* protested throughout the crisis (Merrett 1993b).

The response of the colonial governments to the crisis varied. In March 1893 the Victorian treasurer tried to get an assurance that the five members of the Associated Banks with Melbourne headquarters would support each other if one of their members faced a liquidity shock. In return the members would be the preferred banks for government deposits. The banks rejected this proposal. Dowd (1992) blames the Victorian treasurer’s heavy-handed intervention for the Associated Banks’ decision not to provide mutual support. In April the Victorian government declared a week long bank holiday, possibly with the intention of allowing the banks to draft their reconstruction schemes. Most banks defied the holiday, hoping to avoid the impression of a deepening crisis and further erode confidence in the stability of the banks (Fitz-Gibbon and Gizycki 2001). In New South Wales, the colonial government declared all notes of NSW banks legal tender for six months, against the urging of the banks themselves, which were presumably also worried about the effect this would have on confidence (Butlin 1961; Dowd 1992). Furthermore the NSW government issued its own legal tender notes against accounts frozen in suspended banks, and intervened in the liquidation of the Australian Joint Stock Bank, pressuring the liquidator to accept notes from other banks and pay out gold (Fitz-Gibbon and Gizycki 2001).

Almost every bank that had suspended in the first half of 1893 had reconstructed and reopened by mid-August that year. However, the consequences of reconstruction were severe. Of the £65 million of deposits held in banks which ultimately reopened, £9 million was converted into preference shares or interminable deposits. £42 million had been repaid by 1901, but the last repayment to depositors was made as late as 1918 (Royal Commission into Monetary and Banking Systems 1937). In Victoria, the
“bank smash cancelled out the gold rushes and the land boom” (Shann 1930, p. 331). Real GDP per person dropped twenty per cent – twice the contraction experienced in the 1930s – and it took until 1899 for Australia’s real GDP to recover to the level it had reached in 1891 (Fisher and Kent 1999).

3.3 Ideology and banking after the 1890s: the Money Power

Banks had been blamed for causing economic disruption in Australia as early as 1828 (Goodwin 1966). The crash of 1893 coincided with the development of the Australian labour movement. As a result the events and their consequences loomed large in early labour thinking about the shape of capitalism and labour philosophy. Labour thinkers drew two lessons from the depression of the 1890s. First, the banks had too much power over the economy. Banks were prone to monopolisation and, with the property boom, had taken control of too much land. Second, labour writers believed that during the crisis, the colonial governments had acted only in the interests of distressed bankers. The Money Power, as these writers saw it, was an alliance between government and bankers who used their control of banking to expropriate the working classes of their earnings. This was more than simply blaming bank failures for the economic suffering of that decade. Rather, opponents of the Money Power believed that there was a degree of deliberateness to the crisis (Kuhn 1985; Love 1984). The terms of reconstruction were particularly singled out. The typical labour movement view of reconstruction was given in lyrical form: “Of course it very nice is / For shareholders in this crisis, / that past dividends have suffered no deduction; / Though the poor want bread and butter, / Have to sleep perhaps in the gutter, / Their savings will assist in Reconstruction” (Worker (Wagga Wagga), 10 June 1893, p. 4). As one labour publication summed the conception of Money Power:

In New South Wales proprietary Banks own the people, body and soul. They own our gold, coal and silver mines. They own the lands, the cattle, the sheep and the farms and the vineyards. They control
the steam and the sailing fleets. Every Department of Commerce, Trade and Production is systematically exploited by the Joint Stock Shylocks of Banking and Exchange. (Love 1984, p. 33).

In the view of Gollan (1968) the Money Power was an authentic Australian populist movement; an antipodean form of the populist social movements sweeping through the United States. It was usually highly nationalist. With the role of British banks in the financial system, Money Power theorists developed an antipathy towards foreign financiers. It also often manifested in anti-Semitism. Shakespeare’s Shylock and his pound of flesh were a common motif in Money Power writing (the most prominent example being Anstey 1917; see also Coleman 2002).

Hostility to the Money Power focused the attention of the Labor Party on issues of banking and finance. One of its preeminent ideologists, Frank Anstey, who wrote books expounding the Money Power doctrine (1917, 1921), was a minister in the Labor government of James Scullin during the Great Depression, mentor to the Second World War prime minister John Curtin, and “came to personify Labor’s left populist tradition” (Love 2004). Anti-Money Power rhetoric stretched well into the Second World War, even after the more aggressive arguments of the twentieth century’s first decades had subsided. That rhetoric peaked during the 1930s, when the regulatory framework that ought to govern the banking sector was first being seriously considered. Money power ideas informed many of the populist heterodox monetary and banking theories of the era, most notably the Douglas Credit scheme, which had drawn special attention in the 1937 Royal Commission into Monetary and Banking Systems (Berzins 1969; Pullen and Smith 1994; Royal Commission into Monetary and Banking Systems 1937).

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2 As of March 2013, a search in the Trove newspaper database records 1,260 occurrences of “money+power” between 1930 and 1939, compared to 782 in 1920-1929 and 519 in 1940-1949.
3.4 Bank failures during the Great Depression

The banking system that faced the Great Depression was very different from that which faced the 1893 panic. Mergers and amalgamations between 1917 and 1927 meant that at the start of the Great Depression there were just ten trading banks in Australia (Fisher and Kent 1999). The banking sector was both less competitive and its business practices more conservative than it had been in the nineteenth century. Copland (1931, p. 17) was able to write that “Banks are proverbially conservative institutions. They dislike innovations and cling to traditions”; a marked contrast to expansionist banking before the 1893 crash. The bruising experience of colonial banking made banks eager to establish a reputation for soundness, and took a conservative approach to their prudential practices. It was also a less competitive market. Schedvin (1992) argues that the banks in Melbourne and Sydney during the 1920s pursued cartel-like behaviour, colluding on rates and products. Additionally, building societies virtually disappeared as a significant competitor to the banks (Thomson and Abbott 1998).

The major institutional change between Federation and the Great Depression was the establishment of the Commonwealth Bank in 1911 and the Commonwealth takeover of private note issue. For its first few decades, the Commonwealth Bank was less a central bank and more a public competitor to the private banks, providing banking services to governments and depositors (Giblin 1951). Private banks were not required to hold their reserves at the Commonwealth Bank. Nor did the “central bank” have any explicit role or statutory authority to supervise the private banks. It was not until the Commonwealth Bank Act and the Banking Act in 1945 that the Commonwealth Bank became a fully-established and empowered central bank with both monetary and regulatory functions. Nevertheless, the existence of a central bank, however constituted, represented a shift in the institutions of prudential control. Observing the relative accommodation of the private banks to a public sector competitor, Giblin

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3 In 1920 the Commonwealth Bank took control of the Commonwealth Note issue from the Treasury Department.
(1951, p. 5) suggests that the Commonwealth Bank had an implied function as a lender of last resort. The strength of this implication could easily be overstated. The Commonwealth Bank’s lender of last resort responsibilities in the interwar years was ambiguous at best, as the events during the Great Depression were to demonstrate.

The Great Depression of 1929-1939 did not spark the sort of banking crisis in Australia that the country had experienced half a century earlier. There were no major bank failures in Australia in the 1930s, despite a sharp liquidity shock and drain on deposits (Schedvin 1973a). There were, however, a few smaller bank failures. One such failure was the Primary Producers’ Bank of Australia, a Queensland-incorporated bank with 42 branches in various states catering to farmers and graziers. When primary producers suffered rapid drops in the prices of their products, they were unable to repay their loans and others who had deposited funds began to withdraw. The bank suspended payments in 1931. Nevertheless, depositors received 19s. 9d in the £1 – in other words, almost 99 per cent of their original deposits (Royal Commission into Monetary and Banking Systems 1937).

Another bank that failed was the Government Savings Bank of New South Wales (GSB). The origin of the GSB’s failure was political. Yet the negotiations regarding the resolution of that failure foreshadowed much later discussion about the extent to which the Commonwealth Bank should support struggling banks. The Labor Party victory in the October 1930 New South Wales state election directed attention towards the GSB. Labor’s Nationalist opponents argued that the bank and its depositors would have to support the new firebrand premier Jack Lang’s public works program and commodity price guarantees. This led to a drain in deposits, which intensified in early 1931 when the New South Wales Treasury refused to pay a large amount of interest maturing principal on government stock. Further
compounding the public’s lack of confidence in the GSB was a belief that it was subject to political interference (Nairn 1995; Polden 1972).

In March 1931 the GSB began negotiations with the Commonwealth Bank for emergency support. The GSB sought a statement of support from the Commonwealth Bank, to which it was told that the Commonwealth Bank did not wish to “bind itself with any unlimited guarantee in the present state of State Politics” (cited in Polden 1972, p. 62). As the GSB’s finances worsened, Lang sought an amalgamation between the GSB and the Commonwealth Bank. In a statement published on 22 April 1931, the Commonwealth Bank board declined to offer any commitment for support or merger, and the GSB closed that day. Throughout 1931, there were further negotiations about a possible amalgamation. It was not until December that the bank fully reopened, having been merged with the Commonwealth Bank. In the view of Giblin (1951), the slow progress on amalgamation was driven by a conviction within the Commonwealth Bank that there ought to be only one savings bank in Australia. There was an obvious political dimension as well. Deposits in the GSB were guaranteed by the government of NSW (Government Savings Bank Act (NSW) s 44). However the NSW government lacked the funds to make good that guarantee. The financial community saw the GSB’s troubles as a reflection of Jack Lang’s economic mismanagement. Giblin (1951, p. 200) cites the view in Sydney that “Mr. Lang’s financial policy was so disastrous that it was in the public interest to let its evil effects be exposed without alleviation of any kind.” Polden (1972) concludes that the Commonwealth Bank believed that to support the GSB would be tantamount to indirect support of the NSW government and that doing so might have put the solvency of the Commonwealth Bank at risk.

There was no question that the Commonwealth Bank had the power and authority to provide assistance to the GSB, as Joseph Lyons noted from the opposition benches in October 1931 (CPD, House of
Representatives, 16 October 1931, p. 802). Yet the scope of that power was uncertain and its application subject to the Commonwealth Bank’s discretion. During the political debates that accompanied the crisis, Prime Minister James Scullin made an important argument which was to play out a decade and a half later when the next Labor government was preparing banking legislation. Scullin said that “[t]he Commonwealth could not guarantee an institution entirely outside its control” (CPD, House of Representatives, 16 October 1931, p. 800). That the discussion was filtered through a political view about the Lang government simply emphasises that the institutional function of central banking in 1931 could pivot as much on ideological-political grounds as on questions about the safety and soundness of the Commonwealth Bank or GSB. Unsurprisingly many in the labour movement blamed the “oligarchy who control Australia” and their political pawns for the difficulties of the GSB (see, for instance, Sargent 1931). The divisions between Jack Lang and the federal Labor Party meant that within the labour movement Lang received much blame as well.

The relative stability of Australian banks during the Great Depression did not prevent the banking system from being a lightning rod for political controversy. The Commonwealth Bank was at the heart of this. As banker to the government, the Commonwealth Bank imposed strict conditions on deficit financing, which included a requirement that all Australian governments would have to balance their budgets. This prevented the Scullin government from pursuing the expansionary fiscal program that had been advocated by the treasurer Ted Theodore. Furthermore, the Commonwealth Bank and the private banks disagreed with the Scullin government about devaluation in 1929 and 1930 (Butlin and Boyce 1988). Many in Labor and the labour movement saw these disagreements and financial restrictions as a political betrayal. The Commonwealth Bank was supposed to be the ‘people’s bank’ and a weapon against the Money Power. But it appeared to have been captured by the very financial interests it was designed to counter (Giblin 1951). Other resentments were directed towards the private banks, which
the labour movement blamed for the fall of the Scullin government in 1931 and the Lang government in 1932. Butlin (1961) describes the

bitter resentment of the part allegedly played by the banks in the collapse of the Labour governments in New South Wales and in the federal parliament, the hostility of every debtor who believed his fate could have been avoided with proper bank aid, and of every sufferer from depression who at least half-believed that, even [it] if had not been caused by the banks, its worst severity could have been averted but for their wickedness or stupidity (Butlin 1961, p. 406).

Scullin had introduced a Central Reserve Bank Bill in 1930 which would have divided the Commonwealth Bank between its central banking and public banking function. The new central bank would have kept the reserves of the private banks and offered lender of last resort facilities. The bill failed in the Senate. But the experience of the Great Depression, and the first term loss of the Scullin government, made, for the Labor Party at least, a powerful de facto case for urgent legislative change in banking. The disorder costs of relatively laissez faire banking were borne not only by the economy but by the labour movement’s ability to achieve and maintain political power. In this way the Money Power ideology that had first formed in the decade after the crash of 1893 hardened into a political agenda for banking reform in the Labor Party.

3.5 The 1937 Royal Commission

Most political studies of the period pay little attention to the 1934 election (Henderson 2011; White 2000), where the incumbent Lyons government defeated the Labor opposition led by James Scullin, yet that election looms large in the history of financial regulatory change. Scullin had spent most of his term in opposition bitterly focused on the private banks that he felt had caused his government’s downfall in 1931 (Robertson 1974). While bank nationalisation had been part of Labor’s Federal Platform since 1919, it was during this term that bank nationalisation was transmitted onto the party’s election
platform, apparently at the urging of Scullin himself (Sutherlin 1980). Scullin’s 1934 campaign policy speech, delivered at the Richmond Town Hall one month before polling day, is remarkable for its almost singular focus on bank reform (Scullin 1934). Labor’s primary focus was the Commonwealth Bank. Labor wanted to restore the Commonwealth Bank as a people’s bank by replacing the bank’s board with a single governor. Scullin told a Labor branch that “nationalisation by stealth” could be implemented by requiring state banks to do their business with the Commonwealth Bank (Robertson 1974).

In contrast to the Labor opposition, the Lyons government presented itself as a passionate supporter of the private banking system. Joseph Lyons described the private banks as the “sheet anchor of Australia”, crediting their conservative prudential standards with keeping the country from “absolute collapse” and vowing to “stand four square against any interference with them” (The Argus, 6 April 1934, p. 9). The United Australia Party (UAP) election documents stated that the Commonwealth Bank must be “free from the fear or fact of inexpert political control” (United Australia Party 1933, p. 24). Nevertheless, this support for the status quo was not absolute. Central bank reform was actively being considered by the Lyons government. Attorney-General John Latham told parliament in March 1933 that the government intended to split the Commonwealth Bank’s central bank functions from its trading bank functions (Commonwealth Parliamentary Debates, House of Representatives, 31 March 1933, p. 756).

Pressure for bank reform came from the Lyons government’s coalition partner as much as the opposition benches. The agrarian interests represented by the Country Party were particularly affected by the contraction of credit in the early years of the Great Depression (Bell 2004; Sutherlin 1980). The Country Party had called for a Royal Commission into the exchange rate as early as 1932 (Millmow 2010). Many rural voters were attracted to heterodox credit and monetary policy theories, including that of Douglas Credit (Sutherlin 1980). There was substantial ideological cross-fertilisation between the
interest of Country Party constituents in alternative banking systems and the political philosophy of banking being propagated by labour movement thinkers (Berzins 1969; Kuhn 1985; Love 1984). A Douglas Credit Party received just under 5 per cent of lower house votes in the 1934 election. More general political pressure came from the Country Party’s wish for the government to reduce rural indebtedness. A proposal to liquidate rural debt, drawn from Douglas Credit ideas, was even floated privately by the assistant treasurer Walter Massy-Greene (Millmow 2010, p. 164 n. 58).

The result of this political pressure was a Royal Commission into banking. James Scullin had first called for a banking Royal Commission in March 1933. Labor parliamentarians and candidates saw an inquiry as an opportunity to expose the perfidy of the trading banks. With its power to coerce testimony and compel evidence Labor believed a Royal Commission would reveal the “undisclosed profits and hidden reserves” the banks had kept secret in Australia’s hour of need (The Argus, 11 September 1934, p. 8).

Lyons resisted the call for a Royal Commission until August 1934, when, less than three weeks from polling day and under pressure to stem votes leaking from the UAP to the Country Party, he acquiesced to holding an inquiry in his next term of government, adding that he was “only concerned with the banking system to the extent that it had played a wonderful part in assisting Australia out of the depression” (The Sydney Morning Herald, 27 August 1934, p. 9). Butlin (1937) claims that the Royal Commission was announced in response to Labor’s nationalisation policies, but it is clear that pressure from Country Party constituents was also high on Lyons’ mind. A Royal Commission would head off more radical proposals, as the Age editorialised:

The question of how [banking regulation] might be brought up to date should not be allowed to degenerate into a bitter quarrel between the banking system’s apologists and political extremists.

There are other people deeply interested, but they are troubled, even bewildered by the attacks that
are being made and the theories that are being propounded by obviously sincere propagandists with an anti-bank bias. (9 August 1934, p. 8.)

The re-elected Lyons government was in no hurry. The Royal Commission was not appointed until February 1935, and apparently only to pre-empt an inevitable parliamentary request for movement (Sutherlin 1980). Even after the Lyons Cabinet had signed off on the process, it was still another eight months before the commissioners and the terms of reference were announced. The Royal Commission was chaired by Justice John Napier, and its committee was staffed by an accountant, a public servant, one academic economist (Richard Mills, of Sydney University), and a representative of the Country Party (J.P. Abbott, the president of the Graziers Association of New South Wales and later member for the NSW seat of New England). Ben Chifley, who had been Minister for Defence under Scullin but lost his seat of Macquarie in the 1931 election, represented the Labor Party. The government’s terms of reference instructed the commissioners “to inquiry into the monetary and banking systems at present in operation in Australia, and to report whether any, and if so what, alterations are desirable in the interests of the people as a whole, and the manner in which any such alterations should be effected” (Royal Commission into Monetary and Banking Systems 1937, p. 5).

The Royal Commission’s report was tabled in August 1937. For the commission, the objective of the Australian economic system was to maintain full employment of resources and labour under conditions that maximise standards of living, and to reduce fluctuations in economic activity. This result:

will be most likely to follow from a system of central banking in which trading banks and other financial institutions are integral parts of the system, with a central bank which regulates the volume of credit and currency. (Royal Commission into Monetary and Banking Systems 1937, p. 201)
The commission approved the existence of profit-seeking trading banks, “provided that their charges for service to the community are reasonable” (p. 207), but wanted the Commonwealth Bank to regulate credit in such a way that credit was expanded and contracted countercyclically, rather than procyclically. For this reason, the commission felt that private banks “must bear some responsibility” (p. 218) for the extent of the Great Depression, as they had intensified the economic downturn.

The most politically significant conclusions of the Royal Commission were its dismissal of bank nationalisation and argument that the Commonwealth Bank should be subject to political control. The report’s argument against nationalisation was airily brief: “We have not entered into the arguments for and against the nationalization of banking in Australia” (p. 252). A dissenting appendix by Chifley dutifully made the Labor Party’s case against private banking and for nationalisation. However, as Butlin (1937, p. 49) perceptively noted, despite the apparent rejection of nationalisation, the report’s findings into the failures of the existing banking system were, implicitly, an acceptance of the Labor criticism of the private banks. On the subject of political control, the report argued that if the government and Commonwealth Bank board disagreed with what action was in the “national interest”, then, “after full and frank discussion”, it was “the duty of the Bank ... to carry out the policy of the Government” (p. 206). This would prevent the Commonwealth Bank from holding up a future government’s plans for fiscal expansionism and devaluation as had happened during the Great Depression. H.C. Coombs wrote that this formulation “shook the doctrinal foundations of the Bank”, which had been proud of its independence (cited in Bell 2004, p. 10). Yet the complex formulation was seen by the commission as a halfway house between full government control and full independence (Schedvin 1992).
3.5.1 Prudential regulation in the Royal Commission

Prudential regulation was not a major focus of the Royal Commission’s report, and its proposals in that area were underdeveloped. Nevertheless, it made a substantial number of recommendations that were to define prudential regulation for the next few decades. First, the Royal Commission established a clear Commonwealth Bank responsibility for maintaining the stability of the banking system. Reasoning from the fact that the failure of a single bank could “seriously threaten the stability of the whole system,” the Royal Commission argued that “it would appear to be the responsibility of the central bank to consider whether the actions of any bank are in conformity with the public interest” (Royal Commission into Monetary and Banking Systems 1937, p. 235). In the first instance, the Commonwealth Bank would be expected to approach the bank in question about their prudential practices. If this was insufficient, then “it might be necessary for the Commonwealth Bank to exercise some of its powers to make it difficult or impossible for the offending institution to continue the course to which objection was taken” (p. 236). Central to the success of this policy approach was the provision of information about bank activities.

The Royal Commission recommended a step by step process for the Commonwealth Bank to resolve illiquid and insolvent banks. If a bank was unable to meet its obligations, the Commonwealth Bank would promptly conduct a thorough investigation into its affairs. If the bank was found to be merely suffering liquidity problems, the commission considered that a Commonwealth Bank announcement that the bank in question was sound might reduce alarm and the possibility of a bank run. If this was seen to be inadequate, the Commonwealth Bank might guarantee the deposits of the individual stricken bank, “provided that it were given adequate security and some control over the bank” (p. 236). It is important to note that the Royal Commission did not support an absolute guarantee of depositor funds. Rather, it saw deposit guarantees as a discretionary tool to be used, if needed, by the Commonwealth Bank to restore confidence in solvent but illiquid banks and to prevent runs.
By contrast, if a bank was insolvent, the Commonwealth Bank would appoint a receiver for depositors. The Royal Commission was clear that depositors could not expect their whole deposit to be recovered. “As soon as [the Commonwealth Bank] is in a position to do so, it should announce its estimate of the amount which the depositors may expect to receive, and make arrangements for the release of part of their deposits to those in need.” Furthermore, the commission was careful to point out that it was not concerned with the protection of shareholders, as “it is within their power to safeguard their own interests” and that this arrangement would not be extended outside the banking system (p. 236). With these statements, the Royal Commission was explicit that was solely concerned with the stability of the banking system, rather than depositor or shareholder protection.

The Royal Commission proposed other regulatory controls that in later decades came to be seen as prudential controls. One was the minimum reserve requirements to be held at the central bank. The Royal Commission however saw these requirements as primarily a monetary rather than prudential policy. Some private banks had been keeping a small portion of their reserves as deposits with the Commonwealth Bank well before the Royal Commission. To encourage this practice, in 1928 the Commonwealth Bank gave an undertaking that any reserves held would not be used to compete with the private banks. A substantial increase in bank deposits at the Commonwealth Bank came with the central bank acquisition of sterling in August 1930 as part of the mobilization agreement to tackle the Great Depression (Schedvin 1992). While the Royal Commission rejected a regulatory minimum requirement for trading banks to keep fixed reserves with the Commonwealth Bank, it proposed instead that the Commonwealth Bank be given discretionary power to impose minimum reserve requirements when needed in a crisis. The use of the power required the consent of the treasurer, and would be subject to strict time limits. Nevertheless, the Royal Commission conceived of this temporary reserve requirement as a core part of the Commonwealth Bank’s crisis management powers. With control over
minimum deposits, the Commonwealth Bank would be able to control total bank lending, and would use that control to adjust and smooth credit fluctuations when necessary.

The assumptions in the Royal Commission’s report shaped the next few decades of financial and banking regulation. As Schedvin (1992) argues the Royal Commission reflected the popular faith that central bank supervision over private banks would be able bring greater economic stability than had been experienced during the Great Depression. Yet that central assumption was neither explicitly stated nor defended directly in the commission’s report. In the Royal Commission we see a shift in normative ideas about the role of the state in the banking sector which laid the intellectual groundwork for the financial repression that characterised banking regulation for the next five decades.

3.6 Towards financial repression
Taken together, the Royal Commission’s recommendations would have vested the Commonwealth Bank with all the basic features of central banking, as well as substantial discretionary power and responsibility for economic management. The road to these central banking powers was, however, not linear. It was not obvious in the late 1930s that the Commonwealth Bank could shoulder this sort of responsibility. The private banking community believed that the current Commonwealth Bank board and its advisors were “unrealistically theoretical.” This sentiment was echoed within the Lyons government, where there were doubts that the chairman of the Commonwealth Bank board would be able to use their vast new powers with “adequate wisdom” (Giblin 1951, pp. 232-3).

After a short delay, the private banks expressed their opposition to the recommendations – particularly the proposed Commonwealth Bank minimum reserve deposit power – publicly and forcefully. The Chairman of the Bank of Adelaide objected that the commission’s recommendations would “place the whole banking system under political control” (Sutherlin 1980, p. 226). A private communication from
the Associated Banks to the Lyons government outlined in detail the trading bank’s response. The
Associated Banks protested that

The gravest danger appears to us to lie in individual recommendations which would subject both the
Commonwealth Bank and the trading banks to the changing fortunes of politics. It is essential to any
financial system that it should command confidence, and nothing is more disturbing to confidence
than a system liable to a change of policy with a change of government (NAA A571 1938/731 PART 1).

The Associated Banks did not refer to the proposed bank resolution procedures. But they made a
broader point about the mixture of cooperation and coercion, arguing that only the former offered the
productive flexibility necessary for smooth central banking operations. The Associated Banks argued
that in times of financial crisis there was likely to be political pressure for large increases in the minimum
reserve. Prudent bankers would consequently keep large reserves in anticipation of future legal
requirements, creating a de facto legal imposition (NAA A571 1938/731 PART 1).

in November 1938 the Lyons government brought a Commonwealth Bank Bill to parliament. The
legislation focused for the most part on the establishment of a mortgage bank. But it also included what
Treasurer R.G. Casey called some “changes of a minor character” (CPD, House of Representatives, 6
December 1938, p. 2704). Among these was a provision to implement the Royal Commission’s
recommendations concerning Commonwealth Bank takeovers of insolvent banks. The details of this
provision will be explored in the next chapter. In the event the bill did not move past its second reading
stage. A Banks Bill was produced in draft form during 1938 but was not finalised for public release
(Giblin 1951). The death of Joseph Lyons and redirection of Canberra’s attention to the imminent war
meant that the full legislative response to the Royal Commission never came. When banking regulation
was introduced it was in a vastly different political and economic context – the mobilisation of resources for waging total war.

3.6.1 Banking control in the interests of national security

The institutional framework under which regulatory controls can be introduced in peacetime and wartime in Australia are substantially different. Section 51 (vi) of the Australian Constitution provides the Commonwealth government with the power to make laws governing “the naval and military defence of the Commonwealth and of the several States, and the control of the forces to execute and maintain the laws of the Commonwealth”. Known as the ‘Defence Power’, during the First World War this section was construed by the High Court as to provide virtually absolute powers to the Commonwealth government for its facilitation of the war effort. Likewise the Second World War bought with it a large increase in regulatory and political control by the Commonwealth government. As Galligan (1987, p. 118) writes “National survival and total war necessitated such controls, while the defence power that virtually suspended the rest of the constitution in such circumstances allowed them.” Nevertheless, the changed constitutional environment did not immediately drive the UAP government towards regulatory reform in the financial sector. While capital controls were introduced just six days after the war started, and the National Security Act 1939 required all receipt of foreign exchange to be sold by the Commonwealth Bank, for the first years of war financial activity was restricted through voluntary agreements between the government and the banks.

Likewise, the onset of war brought about a dramatically changed fiscal environment. Between 1938 and 1943 total government expenditure – including Commonwealth, state and local governments - leapt from 23 per cent of GDP to 49 per cent of GDP (De Maria 1991; Novak 2013). By early 1941 the government and Commonwealth Bank became concerned this rapid fiscal expansion was increasing the
private trading banks’ liquidity, and that the banks would respond by increasing advances and making
greater profits. The solution devised by the central bank was a voluntary undertaking to limit bank
profits and divest the excess liquidity with the Commonwealth Bank (Arndt 1956; Giblin 1951). However,
the progress towards such a system was interrupted by the political turmoil inside the UAP – turmoil
which ultimately led to the UAP government’s demise.

The Labor Party was appointed as a minority government in October 1941 and quickly turned its
attention to introducing banking regulation under the Defence Power. Prime Minister John Curtin
appointed Ben Chifley (who had been returned to parliament in the 1940 election) as his treasurer.
Labor had not been in power federally since the demise of the Scullin government ten years earlier.
Banking and monetary reform were pressing when they left power, but for many in the labour
movement, the war made such reforms doubly urgent. Money Power rhetoric changed to suit the new
wartime circumstances. Jack Beasley, of the Lang breakaway Labor Party, argued in 1941 that the full
war effort had not been applied because “the growth of monopoly and money power ... is preventing
that degree of production which is necessary” (The Mercury, 3 February 1941, p. 2). Shortly after it took
power, the Curtin government announced its intentions to regulate the banks along the lines of the
recommendations of the Royal Commission (Butlin 1955). Curtin told an interviewer that only Labor
took the commission’s recommendations seriously (Crisp 1960).

The new treasurer quickly turned his attention to banking controls. The National Security (War-Time
Banking Control) Regulations were introduced on 26 November 1941. These controls imposed the
scheme of bank licenses as recommended by the Royal Commission. Fourteen Australian banks named
in the regulations were granted licences and required to lodge a special account with the
Commonwealth Bank to hold “surplus investable funds”, defined as any amount exceeding that held by
the banks in August 1939. The Commonwealth Bank would pay interest on these funds at a rate unspecified in the regulations. The regulations also provided for broad supervisory and regulatory powers over bank advance policy, stating that “[i]n making advances a trading bank shall comply with the policy laid down by the Commonwealth Bank from time to time”. A few months later these regulations were given further force by the National Security (Economic Organisation) Regulations, gazetted on 20 February 1942. These regulations were instituted to enable the Curtin government’s National Economic Plan, which, along with National Security (Mobilisation of Services and Property) Regulations, were intended to effect the “total mobilisation and ordering of all the resources, of Australia on a Commonwealth-wide basis, to ensure the defence of our country” (The Advertiser, 18 February 1942, p. 1). The economic organisation regulations capped profits across the economy, introduced broad price controls, severely restricted property and share transfers to restrain ‘speculation’, and pegged wages to the rate being paid in February 1942 (Butlin and Schedvin 1977). Trading margins were pegged two months later (Bambrick 1972). The National Economic Plan also gave the Commonwealth Bank direct control over interest rates.

With the regulatory controls of November 1941 and early 1942, the Commonwealth Bank was granted near absolute regulatory control of the banking system. As Schedvin (1992, p. 61) writes, “the degree of control was such as to gladden the heart of the staunchest opponent of the private banks.” The wartime regulations were widely seen as the implementation of the recommendations of the Royal Commission (Canberra Times 31 October 1941, p. 4). It is certainly the case that controls introduced in late 1941 and early 1942 mark the end of the lightly regulated pre-war banking system and the beginning of the post-war regulatory framework. Yet the control exercised by the Commonwealth Bank of the Australian banking system was control for a specific purpose: the management of the financial sector in war conditions. The controls were intended to suppress credit expansion in a time of booming government
outlays and borrowing, to direct resources to sectors necessary for the war, and to prevent unseemly profiteering. While prudential regulation had been a low priority for the Royal Commission, it was an even lower priority for the Labor government in the first years of the war. Labor believed that by implementing the Royal Commission’s recommendations they were taking control of the credit resources of the Australian nation.

That regulatory control over banking was introduced first in wartime explains the relative political ease with which it was imposed. Public acceptance of the social control of industry was at a highpoint in the early years of the conflict (Kemp 1963). The Sydney Morning Herald reported that “after a frank and comparatively brief discussion” with the Curtin government, the trading banks supported the government’s measures, as “the need for central direction of banking policy in time of war has been generally acknowledged” (11 November 1941, p. 6). The chief manager of the National Bank, Leslie McConnan, explained his acceptance of the wartime controls as they did “not provide for much more than we had already offered the [UAP] Fadden government. They will provide for substantially less than we originally expected and I think very much less than a considerable section of the Labour Party desire” (Blainey 1958, pp. 351-2). These perceptions were political constraints on the scope of regulatory change. Where the Lyons government believed the Royal Commission had largely authorised the existing regulatory framework, the Curtin government believed the commission offered a guideline for a sober and moderate socialist interventionism.

Nevertheless, the issue of whether war time controls would be continued into the post-war era was a live question even early in the war. Post-war reconstruction was a blank slate on which many social activists and many of those in the Labor Party saw the opportunity for substantial social reform (Macintyre 2015). John Curtin committed not to directly socialise industries during the war.
Nevertheless, nationalisation was still an item of faith within the labour movement. One senior Labor minister, Eddie Ward, argued in January 1942 that it was “ridiculous to talk of a full war effort while some major industries remained under private control” (The Age, 22 January 1942, p. 2). The Australian Labor Party (ALP) National Conference in June 1943 resolved to conduct a publicity campaign highlighting “the iniquities and fallacies of the private banking system, as a prelude to the nationalisation of banking and the socialisation of credit” (Sydney Morning Herald, 4 June 1943, p. 7).

For those in the government not dedicated to nationalisation, there was a widespread belief that the end of the war would bring with it a depression, and banking regulation would be a key tool in restraining post-war inflation (Myers 1959; Stephens 1976).

3.7 Conclusion

In the space of fifty years the banking sector moved from an unregulated free banking regime where social control was imposed through market discipline to a heavily regulated regime where control was imposed through a mixture of regulation and direct intervention by the Commonwealth Bank. This chapter has identified a number of pivotal moments in the history of Australian banking. After the crash of 1893 the momentum for regulatory change was towards state banking and state takeover of the note issue and ultimately led to the Commonwealth note issue and the Commonwealth Bank. Outside the program of nationalisation advocated by the labour movement, there was no significant proposal for government supervision of prudential risks. The second pivotal moment in banking regulation was the 1934 election, with its singular focus on banking policy and during which Lyons was pulled reluctantly into supporting a banking Royal Commission. Some origins of that myopic focus are easy to identify: the apparent failure of monetary management during the first years of the Great Depression, the considerable personal and political bitterness about the actions of the Commonwealth Bank from the Labor Party and James Scullin in particular, and resentment about the private banks from agrarian
supporters of the Country Party and UAP. But the singularity of that focus from the Labor Party came from the long development of its Money Power ideological frame. The private banks were seen as much as political powers as financial powers, and an inquiry was an opportunity to damage their political position.

Much regulatory reform in this period favoured private interests. Reconstruction schemes after the crash of 1893 favoured bank management at the expense of depositors and other creditors. The Victorian Voluntary Liquidation Act covered up mismanagement and contributed to the worsening of colonial credit in London until it was modified on the eve of the crisis. Likewise many recommendations of the Royal Commission delivered rents to private banks and borrowers. Licensing, when introduced in 1941, was to restrict the number of potential competitors in the banking sector and entrench the cartel-like structure of the industry in the interwar years. Many of those who had agitated for the Royal Commission believed that interest rate regulations would deliver lower interest rates, particularly for the agricultural sector, thus transferring rents to that politically sensitive voting bloc. Similarly, it is easy to identify regulatory change that delivered rents to the government as per the leviathan model. Anger within the Labor Party and labour movement for the downfall of the Scullin government was concentrated on the management structure of the Commonwealth Bank. The single governor model proposed by Labor would give the Commonwealth government authority over the resources of its central bank. Control over the banking sector increased government revenue. Fane (1990) points out that while the amount of revenue raised from these regulatory changes was relatively small, the aggregate net and gross revenue figures available to the Commonwealth do not measure the seigniorage captured by the changes to Commonwealth liquidity in critical moments. Furthermore, “the Commonwealth Bank directly paid for some of the Commonwealth government’s off-budget expenditures and subsidies, such as the provision of subsidised loans” (Fane 1990, p. 23).
How closely does prudential regulatory change during this period accord with a positive public interest model? Economic historians have variously blamed the bank failures of 1893 on inadequate prudential standards (Hickson and Turner 2002) or the actions of the colonial governments during the crisis (Dowd 1992). A positive public interest model might predict that publicly interested governments would introduce regulation to increase prudential standards or implement procedures for governments to respond to bank failure. Yet in the wake of the crisis regulatory attention was not directed towards the prudential failures or crisis management procedures but to the establishment of a state bank and the state takeover of the note issue. Furthermore, when the Commonwealth Bank was established, it was neither established as a central bank and its lender of last resort responsibility was implied at best. It was only until after the Great Depression - which, by contrast, saw few bank failures and little systemic instability - that the Commonwealth Bank was proposed to take responsibility for prudential regulation. However, nineteenth century policymakers cannot be blamed for being ignorant of the policy knowledge of twentieth and twenty-first century economists. The private banks themselves did change their practices to be more conservative, as Schedvin (1973a, 1973b) points out, in response to the crisis of 1893. In this sense the social control represented by market discipline adapted to experience. Furthermore, the Australian government did ultimately introduce both prudential standards and procedures for the resolution of failed banks. The legacy of 1893 was keenly felt by the 1937 Royal Commission, which produced a systematic account of the events and consequences of that crisis. In the parliamentary debate over the Commonwealth Bank and Banking Bill in 1945, the events of half a century earlier were a rhetorical touchstone. The existence of a fifty-year lag between the last systemic banking crisis and the introduction of legislation to prevent a future crisis does not mean the latter was not driven by the former. Societies have to discover that they have made an inefficient institutional choice and have to conceive of alternative institutions before different choices can be made.
This places our focus squarely upon the function of ideas in the subjective political economy framework. Coleman (1999) describes the ‘central bank creationism’ that provided long term momentum for the establishment of a fully endowed Commonwealth Bank. Proposals for colonial state banks long predated 1893 (Gollan 1968; Goodwin 1966) but that crisis gave such proposals a new salience. While the form the Commonwealth Bank took was not as a regulator of the private banks but as a competitor, the ideological importance of the ‘central bank’ was its role in taming financial capitalism. Money Power rhetoric and ideas underpinned the labour movement’s agitation for Commonwealth Bank reform, and the events of the Great Depression gave new content to their claims that the people’s bank had been captured by the private interests that it had been designed to challenge.

Societies do not shift mechanically from one institutional choice on the IPF to another. The crisis of 1893 increased the perceived disorder costs of market discipline as a technique for social control of banking, shifting the IPF curve upwards. For many in the labour movement and for Money Power ideologists, the disorder costs of market discipline in banking came to include not just economic instability but the corruption of the political process and a financial ‘dictatorship’. Simultaneously in this period ideas about social control of regulators and nationalised entities reduced the perceived dictatorship costs of regulatory control and state ownership. For many policymakers, the corresponding efficient point on the IPF moved towards government control and away from market control. However, movement along the IPF is constrained by the availability of alternative institutional choices. As Chapter 2 noted, it is an obvious but important truism that societies cannot choose institutions which they have not first conceived. In this light, the significance of the Royal Commission was to contribute to the development of new points on the IPF that could be adopted.
Even so, the recommendations of the Royal Commission themselves were not determinative of the political choices made after the report was released. As its proposals in the area of prudential regulation were limited, there was ample scope for interpretation about the purpose and function of prudential regulation. The next chapter considers the introduction of the Banking Act 1945 which established prudential regulatory controls in statutory form. By looking at one specific area of prudential regulation - the Commonwealth Bank’s responsibility for depositors in private banks - Chapter 4 shows how the Curtin and Chifley government’s ideas about prudential regulation banks differed from that of its UAP predecessor, and how this disagreement established a principle which was to cast a shadow over banking regulation for seventy years.
4 THE CURTIN-CHIFLEY ORIGINS OF THE AUSTRALIAN BANK DEPOSIT GUARANTEE

4.1 Introduction

In 1945 the Curtin government introduced legislation to regulate the banking sector and formalise the central banking functions of the Commonwealth Bank. This chapter focuses on one key provision in that legislative package to show the political, economic and ideological drivers behind prudential regulatory change in the post-war period. Section 13 of the Banking Act 1945 introduced a mechanism for the Commonwealth Bank to take over banks that could not meet their liabilities. This provision was taken by the Curtin government to be an explicit guarantee of depositors’ funds. The government informed parliament, the public, and, crucially, the Commonwealth Bank itself that this provision was intended to be a government guarantee for the bank deposits of all Australian depositors. The language of that provision remained relatively unchanged throughout many rounds of regulatory reform over the next seven decades.

However, until the Rudd government announced that it would freely guarantee all retail and wholesale deposits in 2008, the Australian government, the RBA, and most academics and commentators denied that any deposit guarantee existed (Edwards and Valentine 1998; Mitchell 2006; Quiggin 2002). At best, the guarantee that existed was considered to be an implicit guarantee; an assumption that the government would, in the case of a bank failure, step in to guarantee deposit liabilities ex post (Gray 2004). Regardless of that repeated denial, there had been a long standing belief held by the public that their bank deposits were guaranteed by the Australian government. A 2006 survey by the RBA suggested that 60 per cent of Australians believed the Commonwealth government either directly guaranteed deposits or, if a bank failed, would ensure they received their money in whole or in part (Reserve Bank

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1 Parts of this chapter have been published as Chris Berg 2015, 'The Curtin–Chifley Origins of the Australian Bank Deposit Guarantee', *Agenda*, vol. 22, no. 1, pp. 21-43.
of Australia 2006). This chapter helps us understand the origins of that perception and raises questions about the status of depositor protection between 1945 and 2008.

A small number of other scholars (Hogan and Sharpe 1990a; Thomson and Abbott 2000) have suggested that the 1945 Banking Act was understood to offer Australian depositors a full guarantee of their deposits. In a brief appendix to a paper outlining the history of prudential regulation in Australia, Hogan and Sharpe (1990a) note that the Chifley government seemed to believe it had instituted a deposit guarantee scheme. Their evidence for this claim is suggestive, rather than definitive. Thomson and Abbott (2000) refer to documents in the archives of the RBA that outline negotiations concerning the shape of the deposit guarantee but do not consider the political and regulatory significance of those documents.

Otherwise, histories of financial regulation in Australia assume that the 1945 Banking Act was not much interested in prudential and depositor protection issues (Giblin 1951; Goldsworthy et al. 2000; Schedvin 1992). The received wisdom is summed up by an Australian Prudential Regulatory Authority paper which states that “the RBA did not guarantee the repayment of deposits. Instead the [Banking] Act conferred a number of powers on the RBA to ensure depositor protection” (Goldsworthy et al. 2000, p. 3). The prudential aspects of the Banking Act have been subject to little scrutiny by economic historians. For example, in his history of the Commonwealth Bank, Giblin (1951) does not look at the relevant provisions of the Banking Act. Schedvin (1992, p. 68) notes the mechanism for Commonwealth Bank takeovers, but does not discuss it in detail, merely commenting that the power was “inspired by the ghost of the 1890s banking crisis”.

Using archival records from the Lyons and Curtin governments, the Attorney General’s Department, and the Commonwealth Bank, this chapter details how the two governments saw the 1937 Royal
Commission’s proposal to deal with insolvent or illiquid banks through significantly different lenses. The first half of the chapter outlines the preparation of the 1945 Banking Act, and considers how the Curtin government negotiated with the Commonwealth Bank as the latter sought to protect itself from the liabilities it believed it would assume in the case of the failure of a private bank. It then considers how parliament understood the depositor protection provisions in the Banking Bill. The second half of the chapter analyses the political economy underpinning the bank deposit guarantee as seen by participants at the time and in the light of the models examined in this thesis. Finally, the chapter skips forward to consider how the RBA saw the bank deposit guarantee in the midst of a crisis at the Bank of Adelaide in 1979, the first time the RBA considered triggering the relevant provisions, as a way of illustrating the central bank’s evolving views about the bank deposit guarantee.

4.2 Bank failures and the 1938 legislation
The Lyons government’s Commonwealth Bank Bill 1938 was the first legislative attempt to outline the prudential responsibilities of Australia’s central bank. While the 1938 bill did not proceed through parliament, the bill shows how the UAP interpreted and sought to implement the Royal Commission’s recommendations. When it came to how the Commonwealth Bank should respond to a bank failure, the legislation prepared by the Lyons government adhered closely to the recommendations of the Royal Commission. Under a heading “Prevention of Bank Failures”, the Royal Commission had recommended that the Commonwealth Bank should be empowered to take over a bank that was unable to meet its obligations (Royal Commission into Monetary and Banking Systems 1937, p. 235). In its response to the Royal Commission, the Commonwealth Bank echoed the Royal Commission’s arguments:

The failure of one bank to meet the demands of its creditors may seriously threaten the stability of the whole banking system … if any trading bank is in difficulties, and either (a) informs the Commonwealth Bank that is unable to meet its immediate obligations; or (b) suspends payment, it is
desirable in the public interest that the Commonwealth Bank be given any additional powers which it may require to take control of the affairs of the bank.

If the business is to be carried on, some assistance, such as a guarantee of deposits or a temporary loan, would probably be necessary ... If the business is to be liquidated, the Commonwealth Bank would require power to appoint a receiver and liquidator. (NAA A571 1938/731 PART 1)

With both the Royal Commission and Commonwealth Bank in agreement, this was the proposed mechanism that the Treasurer R.G. Casey brought to Cabinet in 1937 (NAA A571 1937/4600, p. 125).

One contentious issue in the subsequent UAP Cabinet debate was how much the Commonwealth Bank could compel banks to provide information about their financial well-being. On this question, the Cabinet agreed to limit the Commonwealth Bank’s prudential surveillance powers and rejected a proposal to give the central bank a power to require information from banks. It also rejected a similar recommendation of the Royal Commission which would have empowered the Treasurer to direct the Auditor General to investigate the affairs of any bank, which Casey said ‘presents substantial difficulties’ (NAA A571 1937/4600, p. 133-134). This question of information gathering was echoed in the debate over the Banking Act eight years later with revealingly different results.

Casey’s 1938 bill translated the Royal Commission’s recommendations into the following statutory language:

If any bank informs the Commonwealth Bank of Australia that the first mentioned bank is unable to meet its obligations or if that bank suspends payment, the Commonwealth Bank of Australia may take all or any of the following actions, namely:

a) appoint an officer of the Commonwealth Bank of Australia to investigate the affairs of the first-mentioned bank;
b) assume, for such time as the Board thinks necessary, the control of and carry on during that time the business of that bank; and

c) appoint a person to administer the affairs of the bank or a liquidator to conduct its winding up. (Commonwealth Bank Bill 1937-38 (Cth) s.7AB (Austl.))

However, the death of Lyons and the advent of the Second World War meant that the 1938 legislation proceeded no further, and the bill was shelved for consideration by its successor.

4.3 Preparing the Banking Act 1945

With the end of the war presenting a constitutional deadline for statutory change in banking, in 1943 the Curtin government revisited the Lyons government’s legislation. However, these bills were soon discarded and work began on a fresh pair of bills (Schedvin 1992). In June 1944 the government began consulting with the Commonwealth Bank on detailed technical matters relating to banking (Butlin and Schedvin 1977).

While Curtin and Chifley had begun their government with a pledge to enact the strictures of the Royal Commission, the discussion about what new banking legislation would look like soon went further. Chifley told Cabinet that the government now saw the Royal Commission as “somewhat out of date”, given the controls had been enacted during the war (Crisp 1960). In September 1944 the press started reporting that the federal government would permanently exercise “much closer and deliberate” control over banking than at any time in Australian history (The Age, 26 September 1944, p. 3). The government did not consult the private banks while developing the banking bill. In the early technical discussions between the government and the Commonwealth Bank the former tended to accept the recommendations of the latter without much concern (Butlin and Schedvin 1977). This deference was not to last as the draft bill approached its finalisation.
The federal Cabinet considered the Banking Bill and the Commonwealth Bank Bill in a series of meetings between 10 and 17 January 1945, presided over by the Acting Prime Minister Frank Forde while John Curtin was ill. The question of how the legislation should deal with a bank which was unable to meet its obligations was raised on the last day of those meetings. Rather than simply protecting depositors, as the Lyons government and Royal Commission had proposed, the Cabinet was informed that a “guarantee against loss … would be incorporated the Banking Act”. This guarantee would apply “to depositors as distinct from the Bank itself” (NAA: A2703 VOLUME 1D).

This proposal to guarantee all bank depositors sparked debate among the Curtin Cabinet. Unfortunately Cabinet minutes for the ensuing discussion do not identify the speakers so we are unable to put names to statements. Nevertheless, one objection raised at the meeting was that the guarantee would favour the private banks at the expense of the Commonwealth Bank, which the Labor Party was working to boost as a competitor to the private banking system: “If the Government guaranteed the assets of depositors in private banks people would be encouraged to keep their accounts in the private banks … the private banks would be buttressed up by the provision.” In response, advocates of the provision argued that the guarantee “would become operative only in the case of doubt as to the private banks’ stability” and that “investment in the Commonwealth Bank should be encouraged by emphasising that the Commonwealth Bank was the only bank which had complete stability”. Another objection was raised that “to be consistent” there ought to be a Commonwealth officer stationed in every private bank providing a supervisory function. The bill’s supporters responded by noting that the banks would be “compelled to disclose completely their financial position, including the full market value of their assets” (NAA: A2703, VOLUME 1D).
One participant stated during the meeting was “that it should be made clear that the claims of
depositors will be protected”. The Cabinet finally approved that in the circumstances when the
Commonwealth Bank assumes control of a private bank “the depositors shall be guaranteed the security
of their deposits” (NAA: A2703, VOLUME 1D). However, the final legislation was not to be as
unambiguous.

Records of the Attorney General’s Department show how the Banking Act was redrafted to reflect
changing views within the Curtin government about the purpose of bank takeovers. The Royal
Commission had offered its recommendations about Commonwealth Bank takeovers of illiquid and
insolvent banks under the heading “Prevention of Bank Failures”. In a draft act prepared in late 1944 the
relevant division was titled “Provisions with respect to Banks unable to meet their obligations”. In late
January 1945 the title of this division was rewritten as “Stability of Banks” (NAA A2863 1945/14 PART 2).
Then in early February 1945 – that is, after the Cabinet had debated the purpose of the depositor
protection provisions – the title was rewritten again to become “Protection of Depositors” (NAA A2863
1945/14 PART 4), to reflect the approach endorsed by Cabinet. A similar evolution can be seen in the
marginal note beside section 13 of the bill, which was redrafted between January and February 1945
from a “Supply of information”, to “Commonwealth Bank to safeguard depositors”, and then finally
“Commonwealth Bank to protect depositors” (NAA A2863 1945/14 PART 2; PART 4). These changes in
terminology illustrate the shift in philosophy about the purpose of this provision and the banking
legislation in general.

4.3.1 Negotiating with the Commonwealth Bank

It was only after the Cabinet signed off on the government’s policy that the issue of depositor protection
was discussed with the Commonwealth Bank. Sometime between 17 January and 30 January 1945
Frederick Wheeler, who had been the secretary to the government’s Financial and Economic Policy Committee, informed the central bank that the government intended that “the Commonwealth Bank should guarantee the deposits of a trading bank if and when it assumes control of the affairs of that bank” (RBA archives S-d-78). The proposal caused a flurry of activity within the Commonwealth Bank. The subsequent negotiation between the Commonwealth Bank and the Chifley government illustrates how the Commonwealth Bank saw the significance and effect of the deposit protection provisions, and how the draft legislation was modified to take into account the central bank’s concerns.

The major concern of the Commonwealth Bank was that taking over a distressed bank and guaranteeing its depositors’ funds could mean that any shortfall between the bank’s assets and depositor promises would have to be covered by the Commonwealth Bank. It noted the government had not proposed to allocate any more capital to the Commonwealth Bank to protect against such an occurrence, and it was possible that shouldering these losses could impede the operations of the central bank. In one memo the bank argued that:

In taking control of a bank it might have to assume responsibility for a much larger sum of deposits than the value of the assets it would acquire. In such circumstances the loss should be a national one and it would be reasonable for provision to be made for the Commonwealth Government to guarantee the bank against loss in the event of its assuming control of another bank. (RBA archives, S-d-78)

The Commonwealth Bank emphasised differences between the government’s plans and the other major deposit guarantee system internationally, that provided by the United States’ Federal Deposit Insurance Corporation (FDIC). In a note (undated but likely produced on or around 1 February 1945) the Commonwealth Bank outlined what it saw as the key distinguishing features of the FDIC. The FDIC was a separate entity to the United States Treasury and the Federal Reserve system. It was an insurance
system rather than a blanket guarantee. Banks were required to pay into the FDIC 1/12th of 1 per cent per annum of their deposits in order to qualify for FDIC cover. The amount insured by the FDIC was limited to $5,000 per deposit. Which banks were eligible for cover was at the discretion of the FDIC. Banks seeking insurance had to gain FDIC approval, and banks which the FDIC believed were unsound or had failed to comply with law or regulation could have their FDIC coverage terminated. The Commonwealth Bank’s analysis emphasised the complex supervision arrangements that provided information about banking practices to the FDIC. Furthermore, the FDIC had its own bank examiners for supervisory purposes.

Looking at early drafts of the bill, the Commonwealth Bank observed that it was being expected to take control of a bank only very late in a process of failure, and only at the instigation of the private banks themselves. As the Commonwealth Bank pointedly noted, the FDIC “believes that whenever possible protection to depositors against loss through bank failure should be provided through preventive action rather than by paying off depositors after failure”. Yet it was only after a bank had informed the Commonwealth Bank that it “is likely to become unable to meet its obligations or is about to suspend payment” or if the bank actually became unable to do so would the central bank be able to assume control (RBA archives, S-d-78). This would expose the Commonwealth Bank to liabilities over which it had no influence.

As a consequence, the Commonwealth Bank requested that the final legislation grant extra powers in addition to those in the draft bill: “In the opinion of the officers of the Commonwealth Bank, it is desirable that the Commonwealth Bank should not be asked to assume responsibility for the repayment of deposits with other banks unless it is given suitable power to take preventive measures against bank failures.” (RBA archives, S-d-78). The first additional power was a discretionary power to assume control
of a trading bank “which the Commonwealth Bank considers may become unable to meet its obligations” (emphasis added). This way the Commonwealth Bank would be able to take pre-emptive action and hopefully re-establish a bank’s soundness before it became insolvent.

The second additional power the Commonwealth Bank requested was the ability “to maintain a continuous detailed inspection of the affairs of each bank” (RBA archives, S-d-78). The draft bill seen by the Commonwealth Bank provided for periodic investigations of the books, accounts and transactions of each bank by the Auditor-General. These powers had been a recommendation of the Royal Commission, yet had been rejected by the Lyons Cabinet as too intrusive. However, as the government was now asking the Commonwealth Bank to blanket guarantee depositors’ funds, the Commonwealth Bank believed that Auditor-General supervision by itself was inadequate to the task. In the Commonwealth Bank’s view, the Auditor-General would not have the “technical skill and expertise of a trained banker” in determining whether a banks’ investments “have been, and are being, wisely made”. In its view, the Auditor-General’s periodic audits should be supplemented by direct Commonwealth Bank investigatory powers (RBA archives, S-d-78).

The third power that the Commonwealth Bank requested was the ability “to give directions to banks about individual advances, investment, reserves and dividends” (RBA archives, S-d-78). This would constitute far more expansive prudential control over the banking sector than had been envisioned previously, and far exceeded the intent of the Royal Commission, as well as the Lyons and Chifley government, each of which saw control of advances policy to be an instrument of monetary policy, rather than a prudential control. One Commonwealth Bank memo spells out the far reaching implications of the deposit guarantee and the implied control over banking business.
[t]he suggested obligation upon the Bank to guarantee other bank deposits appears to cut across other provisions in the draft legislation.

For example, unless the Commonwealth Bank, in addition to the power to inspect, has power to assume control, it would have to have the power to inspect and to direct a bank regarding its investments. This would, in effect, take the management of another bank out of its own hands ... The power to direct would have to be applied in individual cases, whereas the whole intention of the advance policy provision is that broad lines of policy would be delineated ...

The implications of a direct guarantee of the nature proposed are such that it would be contended that this was just an indirect manner of achieving nationalisation. (RBA archives, S-d-78)

The Commonwealth Bank proposed an alternative arrangement, modelled on the FDIC. In this alternative, the government would set up an insurance fund “built up from premiums paid by the banks on their deposits”. The fund would have an inspector of banks, and depositor losses would be borne by the fund. This, in the Commonwealth Bank’s view, would avoid “objectionable” examinations of bank affairs, and eliminate the need for bank takeovers (RBA archives, S-d-78).

The Curtin government did not meet all of the Commonwealth Bank’s requests. It rejected the alternative proposal of an FDIC-like insurance fund. The Labor Party had an antipathy towards contributory schemes that had been shown in the campaign against the Lyon’s government’s proposed national insurance scheme (Coleman, Cornish and Haggar 2006; Watts 1987). It also declined to allot the Commonwealth Bank new funds. However, the proposal presented to the Labor caucus in late February 1945 and the bill presented to parliament in March granted many of the other powers the Commonwealth Bank had requested. The final bill allowed the Commonwealth Bank to require any bank to supply information to it relating to financial stability, and, if a bank failed to comply, appoint an officer to directly investigate the bank’s affairs. Similarly, the proposal brought to caucus specifically
noted that the Commonwealth Bank could assume control of a bank which is unable to meet its obligations “according to its own statement or in the opinion of the Commonwealth Bank” (The Advertiser, 21 February 1945, p.5). The final bill also provided for a range of penalties if the newly taken-over bank did not grant the Commonwealth Bank access to its financial information or submit its business to the Commonwealth Bank.

The Banking Bill was introduced into parliament on 9 March 1945, alongside the Commonwealth Bank Bill 1945. Protection of depositors was covered under Division 2 of the bill. Section 11 read that “It shall be the duty of the Commonwealth Bank to exercise its powers and functions under this Division for the protection of the depositors of the several banks” (Banking Bill 1945 (Cth) s.11 (Austl.)). The mechanism for resolving bank failures appeared in section 13, and stated that:

(1.) A bank which considers that it is likely to become unable to meet its obligations, or is about to suspend payment, shall forthwith inform the Commonwealth Bank.

(2.) Where a bank -

(a) so informs the Commonwealth Bank;

(b) becomes unable to meet its obligations or suspends payment; or

(c) in the opinion of the Commonwealth Bank, is likely to become unable to meet its obligations or is about to suspend payment,

the Commonwealth Bank may -

(d) appoint an officer of the Commonwealth Bank to investigate the affairs of the bank concerned; and

(e) assume control of and carry on the business of that bank ...
(5.) Where the Commonwealth Bank has, in pursuance of subsection (2.) of this section, assumed control of the business of the bank, the Commonwealth Bank shall, subject to the next succeeding subsection, remain in control of and continue to carry on, the business of that bank until such time as –

(a) the deposits with the bank have been repaid or the Commonwealth Bank is satisfied that suitable provision has been made for their repayment; and

(b) in the opinion of the Commonwealth Bank it is no longer necessary for the Commonwealth Bank to remain in control of the business of the bank. (Banking Bill 1945 (Cth) s.13 (Austl.)).

Yet the legislation as written leaves us with a puzzle. Despite the Cabinet endorsement and subsequent negotiation with the Commonwealth Bank, there is nothing in the provisions introduced to parliament that explicitly states that deposits were to be guaranteed. Indeed, these provisions are perfectly internally consistent with the absence of a deposit guarantee. First, much was left to the Commonwealth Bank’s discretion. The Commonwealth Bank “may” assume control of an insolvent or illiquid bank, not “must”. It is unclear what “suitable provision” of deposit repayment would constitute. Second, Section 15 of the Banking Act provided for depositor preference, which would seem to contradict any guarantee of deposits:

In the event of a bank becoming unable to meets its obligations or suspending payment, the assets of the bank shall be available to meet that bank’s deposit liabilities in Australia in priority to all other liabilities of the bank.

In such circumstances as a bank’s assets exceeded liabilities, this suggests it is possible creditors, including depositors, might lose money.
Yet such a plain English reading does not reflect the final agreement of the Curtin government Cabinet, nor with the stated intention of the Curtin government in its discussion with the Commonwealth Bank a month earlier. While the government had not offered an FDIC-like contributory arrangement, it had nonetheless provided the greater supervisory powers which the central bank had argued was necessary in the context of a full deposit guarantee. Furthermore, as the next section shall discuss, Labor parliamentarians believed that Division 2 offered depositors a full guarantee of their funds.

4.3.2 How did parliament understand the bank deposit guarantee?

The Banking Bill was the fulfilment of a promise made by the Victorian ALP thirty-five years earlier when it promised a central bank with “unlimited powers” (Fitzpatrick 1968, p. 168). These bills rewrote all existing banking legislation, refashioning the Commonwealth Bank into a full central bank and eliminating the ambiguities in responsibility and management that had dogged its history since it was formed in 1911. The legislation abolished the Commonwealth Bank Board that had been the target of so much labour movement anger, and replaced it with a single governor model. The bill explicitly instructed the bank to compete for business with the private banks. Finally, the independence of the Commonwealth Bank was dramatically reduced by giving the government the ultimate responsibility for overruling Commonwealth Bank decisions.

The changes to the governance of the Commonwealth Bank and the purposes of monetary policy dominated both the parliamentary and popular debate. Of less political significance was the bank deposit guarantee. Unfortunately the implications of Division 2 of the Banking Bill were not clearly presented to parliament. In his second reading speech on the Banking Bill, Chifley stated that the legislation had been guided by the Royal Commission’s recommendations but also took “additional measures” to meet post-war conditions and learn from the wartime experience of banking control by
regulation. He stated that one of the objects of the legislation was “to safeguard depositors of the banks from loss”. Chifley did not use the word “guarantee” to describe the protection of depositors. He focused mostly on the circumstances under which the Commonwealth Bank’s had a responsibility to assume control of a distressed bank. However, he did object to the “considerable propaganda” which had been distributed in the preceding months suggesting that the interests of depositors “would suffer under the proposed legislation”. In Chifley’s view, the government’s legislation had been deliberately framed to “protect the depositors of the banks” (CPD, House of Representatives, 9 March 1945, p. 554).

Neither was depositor protection a focus of the subsequent parliamentary debate. The Country Party leader Arthur Fadden recognised that the bill provided for protecting depositors against bank failures, but said Chifley “must have had his tongue in his cheek when he thought out that part of his speech” as there had been no bank failures in Australia since 1893, a success which he attributed to amendments to the Commonwealth Bank Bill in 1924, which had handed the note issue over to the Commonwealth Bank (CPD House of Representatives, 22 March 1945, p. 792). The opposition leader Robert Menzies focused much of his objections on the special accounts procedure, which extended the wartime arrangement in which banks were required to lodge surplus funds with the Commonwealth Bank in order to effect profit control and manage inflation. Menzies pointed out that the voluntary arrangement that had been negotiated by the Fadden government in 1941 for the special accounts procedure had explicitly identified that the special accounts would be used for depositor protection, but no such purpose was mentioned in the Banking Bill (CPD House of Representatives, 21 March 1945, p. 750). His concern was that depositors might be told when trying to withdraw their funds that their money had been frozen in the Commonwealth Bank.
Overall, the line of attack presented by the opposition parties was that depositors’ funds would be at risk from the bill, rather than protected by it. The question of Commonwealth Bank governance – the Commonwealth Bank Bill replaced the central bank’s board with a single governor – had become a debate over political control of the Commonwealth Bank, and Labor’s opponents argued that political control threatened the safety of depositors. However, Menzies recognised the existence of the depositor protection mechanism of Commonwealth Bank takeovers, to which he had “no intrinsic objection” (CPD House of Representatives, 21 June 1945, p. 3461). In this charged political debate, it is not obvious how the opposition parties saw the scope of the depositor protection provisions – that is, whether they understood it as a reflection of the Royal Commission’s recommendations or, as the Chifley government intended, a new unconditional guarantee on all deposits no matter the solvency of individual banks.

However, one minor parliamentary debate is both indicative of the opposition’s confusion and suggestive of attitudes towards the proposed scope of depositor protection. On 27 June 1945 the Country Party moved an amendment to replace the words “for the protection of the depositors of the several banks” in section 11 with the words “to ensure that each of the several banks shall meet its liabilities to its depositors, and safeguard the interest of borrowers” (CPD House of Representatives, 27 June 1945 p. 3673). The amendment was intended to underscore the opposition’s argument that the advances policies dictated by the Commonwealth Bank and the special accounts procedure might prevent private banks from meeting their liabilities. The Country Party’s Earle Page told parliament that, as the Commonwealth Bank would have power to “maintain rigid operations of the private banks”, it “should ensure that depositors shall suffer no loss” (CPD House of Representatives, 27 June 1945, p. 3679). Labor parliamentarians dismissed these arguments. Bert Lazzarini, the minister for Home Security and Minister for Works, responded that the government’s legal advisers had satisfied the government
that the provision as written provided “complete protection” for “all persons who have any monetary interest in the private trading banks” (CPD House of Representatives, 27 June 1945 p. 3674). The Country Party amendment was voted down.

Indeed, in the process of defending against claims that the banking legislation placed depositor funds at risk, Labor parliamentarians offered a clearer outline of the purpose behind those provisions than Ben Chifley had when introducing the bill. For instance, Allan Fraser, the Labor member for Eden Monaro, responded to the “deliberate attempt [to] scare the depositors in private trading banks” by saying that “for the first time in the history of this country” banking legislation would “provide a real and an effective guarantee of the safety of bank deposits” (CPD House of Representatives, 5 June 1945, p. 2521). The Labor member for Perth, Tom Burke, said the bill’s regulations would “ensure that the public shall be protected against … losses of money” (CPD House of Representatives, 21 June 1945, p. 3468). The Tasmanian Senator Charles Lamp described the provisions as “the most important in the bill” (CPD Senate 20 July 1945, p. 4338). Charles Morgan, the Labor member for Reid, told parliament that the legislation would have allowed the banks that failed during the Great Depression “to fall back upon the Commonwealth Bank in order to protect their depositors and borrowers” (CPD House of Representatives, 27 June 1945 p. 3674).

4.4 The legacy of two depressions

Parliamentary debate on the Commonwealth Bank Bill and Banking Bill pivoted on the historical experience of bank failures in Australia. Yet the two major failures during the Great Depression did not offer clear political illustrations of the need for depositor protection. Depositors at the Primary Producers’ Bank of Australia had received close to their full deposit in return. In the controversial case of the Government Savings Bank of New South Wales, conservative politicians blamed the actions of the NSW premier Jack Lang, and Labor politicians blamed NSW conservatives for undermining confidence in
the bank. It was, by contrast, the depression of the 1890s that dominated parliament’s understanding of
the fragility of banking. Crisp (1960, p. 181) writes of Ben Chifley drafting the Banking Bill that the “long
memory of the boy from the farm at Limekilns had not forgotten the anguish of 1892-94”. Robert
Menzies argued that the lack of bank failures since 1893 was a result of the private banks having
“learned their lessons” (CPD, House of Representatives, 21 March 1945, p. 744). Eddie Ward, the
Minister for Transport, objected that the opposition had excused the failures of the private banks during
that crisis. In his view, the claim that depositors’ money was at risk from the political control of banking
neglected the fact that it was only thanks to the colonial governments’ efforts at reconstruction which
allowed depositors to recuperate their funds after the failures of 1893, albeit at great delay (CPD, House
of Representatives, 29 May 1945, p. 2207). Labor’s Arthur Calwell argued that the Banking Bill offered
the sort of supervision which the state premiers of New South Wales, South Australia and Victoria had
proposed at a conference in 1893 to handle the crisis (CPD, House of Representatives, 22 June 1945, p.
3547). Darby Riordan, the Labor member for Kennedy, summarised the Labor Party’s perspective on the
legacy of 1893 in the following manner:

The smash of 1893 retarded Australia’s development for many years, because it was not until 1914
that some of the defaulting banks made restitution of some of their clients’ money. It is to avoid a
recurrence of the 1893 debacle that the controls contained in these measures are necessary. This
legislation will be acclaimed as epoch-making. Depositors in trading banks henceforth will, like
depositors in the government bank, have nothing to fear because the proposed controls will ensure
full protection of their money and rights (CPD, House of Representatives, 6 June 1945, p. 2619).

The experience of the Great Depression shaped the Curtin and Chifley government’s views on the role of
government and social policy. In May 1945, while the Banking Bill was before parliament, John Dedman,
the minister for Post-War Reconstruction, tabled the White Paper on Full Employment. The timing was
intentional. The final revisions of the White Paper had been made with the objective of releasing it while both the Banking Bill and the Re-establishment and Employment Bill (which provided for returned service personnel to get priority over civilian job vacancies) were being considered (Butlin and Schedvin 1977). The White Paper presented the Labor government’s demobilisation and reconstruction policies and outlined the shape of the postwar order, stating that full employment was “the fundamental aim of the Commonwealth Government”, and that the government would stimulate spending as needed to achieve this goal. Love (1984) emphasises that the White Paper was seen as a tool to combat established financial interests. The Labor government would ‘civilise’ capitalism by restraining commercial monopolies and empowering the agents of the state. Presenting the White Paper to parliament, Dedman said that it was “closely linked” to the banking reforms, as “the basic purpose of the banking legislation is to ensure that no out-worn financial prejudices or the resistance of vested interests will ever again be a bar to the achievement of full employment” (CPD, House of Representatives, 30 May 1945, p. 2238). In other words, the Chifley government saw its banking legislation as one of the major pegs on which its social and economic policy were hung. Depositor protection was of the same program as social insurance, price controls, national health care, the housing plan, and public works; as Battlin (1994) writes, “socialist ideas were in ferment” within the Curtin and Chifley governments.

4.4.1 Anticipating nationalisation?

The most controversial of those ‘socialist’ ideas was the nationalisation of the banks. Hogan and Sharpe (1990a) offer a provocative interpretation of the Banking Bill’s depositor protection provisions, arguing that the provisions were intended to combat the perception that nationalisation would result in the expropriation of depositors by the state. In this sense the deposit guarantee was an attempt to reduce
the dictatorship costs of nationalisation. The historical record shows a relationship between popular fears of nationalisation and fear that the government would expropriate deposits. Furthermore, after the announcement of Labor’s nationalisation plans in 1947, the existence of the government’s guarantee of deposits was used by advocates of nationalisation to argue that fears of expropriation were unjustified.

Nationalisation remained high on the public agenda after the government made its decision not to push ahead with nationalisation in 1945. The New South Wales Public Service Association resolved in April that year that “nationalisation of banking is fundamental to any just and efficient new order” (The Argus, 5 April 1945, p. 7). When the two bills were presented to Federal Parliamentary Labor Party caucus in late February 1945, an amendment was moved to scrap the proposal and proceed directly to nationalisation of the banking system. Curtin reminded the caucus that Labor had campaigned on nationalisation in the 1931 election and was subsequently tossed out of government (Day 1999). The amendment was defeated. Nevertheless, the government was happy to suggest to its supporters that the banking bills went some way towards nationalisation. Chifley told Cabinet that while his proposals

Did not provide for nationalisation as such they did provide for adequate control and could be accepted as a very definite and substantial step in the direction of nationalisation. If nationalisation were decided upon consideration would have to be given as to how it could be efficiently brought about. (NAA A2703 VOLUME 1D)

Ministers echoed these sentiments in public. Arthur Drakeford, the Minister for Air who was at that time preoccupied with the attempt to nationalise interstate airlines, told a Victorian Labor Party conference that the bills were a “first step” towards nationalisation (Canberra Times, 2 April 1945, p. 2). Likewise,

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2 I have been unable to find any archival records with direct evidence to support this contention.
opponents of the banking bills embraced the predictions of future nationalisation. The opposition argued that political control of the Commonwealth Bank through the single governor model placed the funds of those who held deposits at the Commonwealth Bank at risk. In their argument, state owned banks were susceptible to deposit expropriation. This need to reassure depositors that their funds were safe in state owned banks was part of the Chifley government’s calculation of the likely response to nationalisation. Cabinet was told that “[m]any soldiers, companies, etc. had overdrafts with the private banks. Many would be fearful of the preservation of their equity if nationalisation were suddenly introduced” (NAA A2703 VOLUME 1D).

The 1947 decision to nationalise the private banks directed attention to the Banking Bill’s deposit guarantee. Ben Chifley’s biographers (Crisp 1960; Day 2001) argue that nationalisation was in instigated solely in response to a successful High Court challenge to provisions of the Banking Act that required government authorities to bank solely with the Commonwealth Bank. No serious attempt to lay the public groundwork for nationalisation had been made. While the Banking Bill and Commonwealth Bank Bill had been discussed in the press for months before they were presented to Cabinet, the announcement of nationalisation was a bare one sentence stating the decision and adding the caveat that nationalisation would proceed “with proper protection for the shareholders, depositors, borrowers and the staff of the private banks” (cited in the *Sydney Morning Herald*, 18 August 1947, p. 1). In the subsequent debate, Chifley told parliament that:

> The truth is that the banking legislation of 1945 created a precedent in the financial history of the British Empire. It gave to the people of Australia a guarantee that all depositors would receive their money on demand, even if those deposits were held in a private bank which had gone into liquidation. In effect, the Labour Government was the first government of any country which gave to depositors a guarantee that their interests would be protected ... the Government has endeavoured
to give to those people who have deposited money in private banking institutions what is in effect a
guarantee that they will not lose their money (CPD, House of Representatives, 18 November 1947, p.
2187).

Finally, John Dedman told an audience in the wake of the defeat of nationalisation that “very few people
in Australia to-day were aware that all depositors’ accounts in private trading banks were guaranteed by
the Commonwealth government, under the 1945 Banking Act”. (Port Lincoln Times, 17 November 1949,
p. 2).

4.4.2 The political economy of deposit guarantees
The standard private interest explanation for deposit insurance is that banks seek the subsidy embodied
in deposit insurance, which protects them from the discipline of depositors who might otherwise
withdraw their funds if they detect imprudent behaviour. Deposit insurance subsidises bank risk and
public choice theory suggests therefore that deposit insurance is implemented in the private interest of
bankers (Barth, Caprio and Levine 2006; Kroszner and Strahan 2001; Laeven 2004). For governments,
deposit insurance allows regulators to impose imprudent lending practices on the banks as repayment
for the subsidy. The complexity of deposit insurance incentives make it hard for taxpayers – who may
also be depositors – to identify the winners and losers from the policy. As Calomiris and Haber (2014, p.
36) write, government safety nets are “typically designed to minimize the public visibility of the costs of
bailouts and the allocation of the losses”. In a 1973 debate over the extension of Commonwealth
control to NBFIs, the then-prime minister Gough Whitlam gave a rare, explicit statement of quid pro quo
whereby deposit insurance allows governments to deliver rents to politically favoured constituencies. In
Whitlam’s view, the Australian government secures banks against loss in order to establish the right to
direct banks’ advances policy:
No bank registered under Australian Parliament legislation can go bankrupt. In return for that guarantee against loss, banks pursue a lending policy which the government of the day approves. In the case where there is a dispute over government banks, the government of the day has to make a report to the Parliament as to why it wants its will to prevail. There is no need for people to get agitated on this subject. It would be a very proper thing for this Parliament now to see that such basic financial institutions as building societies are equated much more in their operations to banks - that is, we should guarantee their security and, in return, they should pursue the public interest in their lending policies. (CPD, House of Representatives, 23 May 1973)

In this light, the introduction of the deposit guarantee in the 1945 Banking Act provides a partial explanation for the broader prudential powers of the Commonwealth Bank. In the 1945 negotiations the Commonwealth Bank was granted coercive power to obtain information about bank operations, and was given the power to instigate takeovers of private banks rather than wait for banks to report their own troubles. However, from the Commonwealth Bank’s perspective these powers were obtained at the cost of bearing the liability for bank losses. The government declined to give the central bank any FDIC-style fund to provide for potential losses. The political income of a deposit guarantee accrued largely to the government rather than the central bank. The private banks themselves received not only the implicit subsidy of a deposit guarantee but a range of other regulatory benefits from the Banking Act. Later chapters will discuss the prudential significance of barriers to bank entry, but for now it should be noted that the requirement that all banks receive a licence from the Treasurer was a substantial constraint on potential competition in banking. Such barriers to entry delivered rents to the private banks (Djankov et al. 2002a). In return for these benefits, the government obtained rents for itself and which it could deliver to its supporters.
These rents were substantial and in demand. The crisis of government finance in the first years of the Depression looms large in the wartime regulations and 1945 legislation. The provision of special accounts under national security regulations gave the Commonwealth Bank a large amount of cash to buy government bonds. The decision to set the limit on surplus investable to that held nearly two years earlier – August 1939 – meant that £20,000,000 was immediately called to the Commonwealth Bank (Butlin 1961). While the private banks were able to withdraw funds from the special accounts with the approval of the Commonwealth Bank, this practice was rare, and the volume held by the central bank increased rapidly between 1941 and 1945. When the war ended, £221,000,000 was held in the special accounts (Commonwealth Bank of Australia 1947). Control of interest rates was used to encourage a shift from trading bank fixed deposits to public loans (Butlin and Schedvin 1977). Furthermore, the 1945 legislation gave the Commonwealth Bank a right to call any increase in assets since August 1945. By the time the Menzies government amended the Banking Act in 1953, the private banks had £500,000,000 in uncalled liabilities from this mechanism, a “virtual sword of Damocles” hanging over their head (Kemp 1953).

The 1945 legislative package had other mechanisms to control the flow of credit to favoured groups. The Commonwealth Bank’s control over interest rates and control over advances policy narrowly prescribed what private banks could loan for and how much. The Rural Credits Department (established in 1925 under the Country-Nationalist coalition government) and Mortgage Bank Department (established in 1943) of the Commonwealth Bank provided subsidised loans to favoured sectors. Likewise a new Industrial Finance Department was established in order to provide loans to industry below market prudential standards. The “attitude” which the new department was to have as regards to the loans it would provide “should not be what is commonly expressed as a banking attitude, but of necessity should be one of liberal discretion” (Jones 2001, p. 179). Finally, the Commonwealth Bank Act 1945
made special provision for preferential loans for new housing “to be made at the lowest practicable rates of interest”. In sum, the 1945 legislative package allowed governments to deliver substantially more rents to favoured groups, while the banks benefited from the subsidy of deposit guarantee and protection against new bank entry.

4.5 The deposit guarantee and the Bank of Adelaide crisis
The mechanism through which the Curtin-Chifley government believed deposits were guaranteed has never been tested. However, in 1979 the RBA3 did consider a takeover of the Bank of Adelaide under the Banking Act. Discussions within the RBA about the viability of this process give us a picture of how the central bank saw its obligations to depositors before the reforms to financial regulation in the 1980s.

In early 1979 the Bank of Adelaide faced imminent failure. The crisis was caused by the fact that its wholly-owned subsidiary, the Financial Corporation of Australia (FCA), was virtually insolvent (Merrett 1985). As the Bank of Adelaide’s capital was not sufficient to cover FCA’s losses, in April 1979 it sought to merge with a larger bank. It obtained an offer from the British-owned Standard Chartered Bank but such a merger would have violated foreign investment restrictions. It also sought but failed to make an agreement with the Bank of NSW (Fitz-Gibbon and Gisycki 2001; Sykes 1988). Finally, the Bank of Adelaide started looking for support from the federal government and the RBA. In a meeting on 5 May 1979, the RBA offered the bank an ultimatum: it was to find a larger Australian trading bank to merge with under any terms. Unless arrangements for a merger were made, the RBA would use its powers under section 13 of the Banking Act to take over operation of the bank (RBA archives D08-53041). This would occur, RBA governor Harry Knight allegedly told the Bank of Adelaide, “whether it is lawful or not”

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3 The Commonwealth Bank had been divided into two parts by the Reserve Bank Act 1959, which established a Commonwealth Trading Bank for its commercial functions and the Reserve Bank of Australia with its central functions.
(Sydney Morning Herald, 7 November 1979, p. 25). The contested question was whether the Commonwealth Auditor-General would be able to grant the take-over authority to the RBA given that it was the FCA rather than the Bank of Adelaide which was directly in trouble (de Meyrick 2003). While the Bank of Adelaide was not convinced that such authority would be granted, its chairman, Arthur Rymill, explained later that “We recognise the Reserve Bank as our overlord. You don’t argue with those sorts of people” (Sydney Morning Herald, 7 November 1979, p. 25).

The Bank of Adelaide made a final approach to the RBA and the Liberal Fraser government seeking a “statement of guarantee” in the bank. Rymill had been a former state president of the Liberal Party. However, the request was declined in a meeting on 13 May 1979 chaired by Treasurer John Howard. This left Rymill with considerable bitterness about Howard and the Liberal Party for having not returned his service to the party with support at a time of need (Manning 2012). According to de Meyrick (2003) Howard laid responsibility for this decision on Treasury.⁴ A potential merger between the Bank of Adelaide and the ANZ Banking Group was announced on 22 May 1979. The ANZ merger was accepted by Bank of Adelaide shareholders in October 1979, albeit under a cloud of ill-will towards the RBA (de Meyrick 2003, p. 317).

The Bank of Adelaide rescue operation exposed for the RBA the weaknesses of the Banking Act’s depositor protection provisions. Unless it was informed by the Bank of Adelaide that the bank was unable to meet its obligations, the RBA would have to act on a report by the Auditor-General, and action

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⁴ There is no doubt that the Campbell committee forthcoming deliberations was high on the minds of John Howard during these conversations. The Cabinet had begun to defer consideration of prudential regulation of financial intermediaries until after the Campbell committee had concluded its investigations, and in a 15 May Cabinet committee meeting both the Bank of Adelaide and the Campbell committee were discussed in sequence (NAA A13075 8610). In an important interview with Harper (1985) Howard seems to have misremembered the timeline, suggesting that the Campbell committee was partly prompted by this Bank of Adelaide episode; as Chapter 5 will show the committee was instigated in response to an earlier wave of building society and finance company problems.
might be tied up in court (RBA archives D15-268223). Thus the RBA concluded that such action “depends on considerable extent on the good sense” of Bank of Adelaide management (RBA archives D15-217021). Furthermore, there was considerable uncertainty within the RBA as to its obligations in the case of a bank takeover. A memorandum prepared by the RBA’s Banking and Finance Department in April 1979 argued that “insolvent companies should be allowed to die”. However, it also saw a tension between this principle and the fact that “the community has taken special measures to afford investors in certain institutions some protection in the event of default. This attitude is inherent in the protection of depositors as implied in the Banking Act” (RBA archives D15-184639, emphasis added). In practice, RBA officials were assuring worried Bank of Adelaide depositors that the Banking Act’s provisions ensured “they can’t lose money” (RBA archives D15-268229).

4.6 Conclusion
In 2004, the Davis Study of Financial System Guarantees, commissioned by the Howard government in the wake of the collapse of the insurance firm HIH, described the regulatory framework at that time as intended to protect rather than guarantee of depositor funds:

When dealing with the insolvency of a financial institution, the prudential framework tries to ensure that there is sufficient leeway to identify and manage the exit of a troubled institution before significant losses to certain stakeholders accrue. However, this is not always possible and the customers and other creditors of a financial institution may not always be repaid in full. (Davis 2004)

Yet to a significant degree the provisions governing banks which are unable to meet their obligations to depositors had remained the same between 1945 and 2004. The Banking Act 1945 was superseded by the Banking Act 1959, which transferred the provisions with negligible change. Those provisions remained intact up to the establishment of the Australian Prudential Regulatory Authority (APRA) in 1998. Amendments to the Banking Act in 1998 made specific provision for insolvent ‘authorised deposit-
taking institutions’ (ADIs) to be wound up under corporations law, and granted the depositor priority that banks had been subject to since 1945. Yet the Banking Act maintained the process formulated by the original 1945 act by which banks – now all ADIs – are taken over, but now by APRA rather than the Reserve Bank. Even after the introduction of the Rudd government’s Financial Claims Scheme in 2008, the Banking Act 1959 provides that APRA terminate its control of an ADI either when “deposit liabilities have been repaid or APRA is satisfied that suitable provision has been made for their repayment”.

This history calls out for explanation. The clear legislative intent of the Curtin-Chifley government was that the Commonwealth Bank would guarantee depositors’ funds in the case of a bank failure. This is what Ben Chifley told the Cabinet, Labor members told the parliament, the government told the Commonwealth Bank, and Labor supporters told the public in later years. However, the text of the Banking Act did not explicitly reflect this guarantee. Indeed, as written, the relevant provisions of the Banking Act differed in only minor ways from parallel provisions in the Lyons’ government’s proposed banking legislation, which was deliberately not intended as a blanket guarantee of depositors. The deposit guarantee presented in 1945 was explicit – announced and understood as such - but it was not explicit in statute.

There are a few potential implications of the finding in this chapter. It is possible that over time the RBA deliberately interpreted the Banking Act against the original intent of parliament. Denying that an explicit guarantee existed relieved the RBA of financial liability for depositors of failed banks. Alternatively, the provision’s disuse – there were three decades between the parliamentary debate and the consideration of taking over the Bank of Adelaide – meant that institutional memory of the 1945 discussions was lost. An ahistorical reading of the Banking Act would make Division 2 look unproblematic. Certainly the challenge of simply taking control of the Bank of Adelaide was formidable.
enough without considering how to respond to depositors’ demands once control was achieved.

Explanations for why the Curtin government failed to give surer statutory footing to their intent are
going to be even more speculative.

The Financial Stability Forum (2001) emphasises that an effective deposit insurance system is one in
which the scope and limitations of the guarantee are well-known and understood by the public (see also
Garcia 1999). Yet how well the public understands deposit guarantees has attracted surprisingly little
study (Bartiloro 2011; Bowyer et al. 1986; Inakura and Shimizutani 2010; Reserve Bank of Australia 2006;
Sträter et al. 2008). However the legislation was to be interpreted by policymakers in later decades, the
Curtin-Chifley government fuelled a public perception that the Commonwealth Bank would bail out
depositors in a failed bank. In subsequent decades the RBA tried to row back this perception by stating
that no such guarantee existed, and that depositors needed to exercise discipline through the market
and monitor their bank’s performance. Their attempts to manage these perceptions would have been
negatively affected by the Victorian government’s guarantee of depositors of the State Bank Victoria in
1990 and the Commonwealth support for the insurance firm HIH in 2001, discussed later in this thesis.

When the Rudd government guaranteed all ADI depositors in 2008, this can be seen as a regression to
the policy of its Labor predecessors six decades earlier.

The Curtin-Chifley government’s bank deposit guarantee is more than a historical curiosity. The Banking
Act represents less the implementation of a guarantee and more the early establishment of the principle
that bank deposits, regardless of whether they were held in state banks or private banks, were to be
risk-free for depositors. In later decades the certainty of bank deposits would be a path dependent
limiting factor on regulatory change. The deposit guarantee also brought with it conceptual problems.
For example, should depositors in building societies receive the same treatment and protection as
deposits in banks? The next two chapters looks at the boundary problems that arose from the growth of the building society industry in the post-war decades, and how those problems led to a wholesale restructuring of the Australian economy.
5 BOUNDARY PROBLEMS AND THE FINANCIAL CORPORATIONS ACT

5.1 Introduction

Goodhart (2008) and Brunnermeier et al. (2009) write about “boundary problems” in financial regulation. If regulation is effective, regulated sectors are likely less profitable and have a lower return on capital. Profit-maximising business will shift from regulated sectors to non-regulated sectors as they search for higher returns. Regulated firms will open subsidiaries in the non-regulated sector to take advantage of the higher profits there. Where regulated firms enjoy the benefits of regulation - such as implied or explicit government guarantees - funds will tend to flow into unregulated sectors in good times and into regulated sectors in bad times, as they chase profits or security respectively. As Brunnermeier et al. (2009) point out, there can be no ‘level-playing field’ in such a system, regulation will be vulnerable to arbitrage, and the intentions of policy makers are likely to be subverted.

This chapter considers how one such boundary problem - that between banks and non-bank financial intermediaries (NBFIs) - became a pivot on which Australia’s regulatory history turned. In the standard account of the factors that led to financial regulatory change in the 1980s, the growth of NBFIs looms large. NBFIs were taking market share from trading banks, leading to a two-tiered financial sector between banks and non-banks, and reducing the effectiveness of regulatory controls on banks. For instance, Martin (1999, p. 122) credits the commissioning of the Campbell committee to a “growing dissatisfaction with the performance of financial regulation.” Fraser and Simons (2010) likewise focus on weaknesses caused by the differential regulation between banks and NBFIs. The Fraser government’s 1981 Committee of Inquiry into the Australian Financial System (the ‘Campbell committee’) credited the growth of NBFIs for the financial sector distortions it sought to rectify (Committee of Inquiry into the

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However, this traditional public interest story needs modification. This chapter provides a new interpretation of the decisions which led to the establishment of the Campbell committee. While Cabinet records of the Fraser government have been used by scholars ever since Ayres (1987), this chapter sees the Whitlam and Fraser government operating in tandem, as the legislative decisions of the former determined the regulatory choices faced by the latter. This chapter integrates the Whitlam government’s Financial Corporations Act 1974 into the history of Australian regulatory change. The only major study of the Financial Corporations Act is Taylor (1975) - published before the significance of the legislation for future reform became clear. Otherwise, histories of financial change pay scant attention to the Whitlam government’s approach to financial regulation. Yet it is in Cabinet-level discussion during the Fraser government concerning the Financial Corporations Act that we can see the original spark that led to microeconomic reform of the Australian economy. Brunnermeier et al. (2009) distinguish between two ways that boundary problems can be definitively resolved: free banking or complete control, arguing that the former would be politically and socially unpalatable and the latter unacceptable in a liberal democracy as, at least at a minimum, regulators would have to prevent cross-border intermediation as well. Australian governments between 1971 and 1978 had to decide whether marginal changes to the regulatory framework would head either in a de- or re-regulatory direction.

This chapter first outlines the institutional context of in which these decisions were made - the economic, constitutional, and regulatory divisions between banks and non-banks. Then it surveys the growth of NBFIs as pressure to regulate the NBFI sector mounted in the post-war years. Finally it provides a legislative and intellectual history of the Financial Corporations Act, and explores how the
political problems created by the unproclaimed Part IV of that Act evolved into the Campbell committee process.

5.2 The institutional context: what is a bank?
Von Mises (1912, p. 261) defines the business of banking as “the negotiation of credit through the loan of other people’s money and the granting of credit through the issue of fiduciary media” such as currency and bank balances. Von Mises notes that these two separate fields of economic activity are linked as much by historical circumstance as their economic attributes. While the first modern banks are typically dated to the government-owned or part-owned banks of the seventeenth century and the private commercial banks of the late eighteenth century (Grossman 2010), the ancient world had institutions that are recognisable as banks in the sense of financial institutions where money was changed, lent and deposited for lending out at interest (Andreau 1999; Millett 1991; Temin 2013).

The complex etymology of the word bank flows through middle French (banc), post-classical Latin (banca, banchus) and Italian (banca). Early uses of the word referred to the sense of a market stall and the moneylender’s counter, from which the English word ‘bench’ is also derived. There was no restriction on the use of the word bank in nineteenth century Australia. During the boom in Victoria many firms appended the word bank to their title in order to raise funds on the London market. Companies like the Victorian Freehold Bank, the Anglo-Australia Bank, the Victorian Deposit and Mortgage Bank, the English and Australian Mortgage Bank were little more than land agents. (Turner 1904).

Section 51 (xiii) of the Australian constitution gives the Commonwealth government legislative power over banks and state banking that extends beyond the limits of a state. Section 51(xx), known as the ‘Corporations Power’, gives the Commonwealth government power over financial corporations formed
within the limits of the Commonwealth. However determining what constitutes a ‘bank’ and a ‘financial corporation’ is a non-trivial question. There was to be no statutory definition of banking in the Banking Act until the Wallis reforms at the end of the twentieth century. Even the Campbell committee had “considerable difficulty” coming to a definition of banking (Scott-Kemmis 1985). Internal government discussions about the Banking Act show how fraught this question was. The Commonwealth Bank queried the Attorney-General’s Department in 1945 about an appropriate definition. The response was that the essence of banking was in its practise of deposit-taking: “many other institutions and persons are engaged in the business of lending money … but that will not, of itself, show that they are carrying out the business of a banker” (Thomson and Abbott 2000, p. 84). At the request of the Treasury, the Commonwealth Bank considered how Victorian legislation, the Banks and Currency Act 1929 (Vic.), defined what was a bank and concluded that in the absence of any specific definition “companies generally accepted and known to be primarily carrying on the business of banking would be subject to the act” (RBA archives S-d-40). Failing to draw any firm conclusions, and wanting to ensure that the legislation comfortably paralleled section 51(xiii) of the Australian Constitution, the Banking Act simply restricted the use of the word “bank”, “banker” and “banking” to authorised companies that had been listed in regulation. In practice this meant that the definition of banking was determined by the status quo as at 1945 and the Treasurer’s discretion.

In the bank nationalisation case, Bank of NSW v Commonwealth (1948) 76 CLR 1, the High Court spent some time discussing what constituted banking and therefore what powers section 51(xiii) conferred on the Commonwealth. In that case, the government argued for a broad definition which would maximise the scope of federal constitutional power. In their view, banking was the creation of credit. Latham CJ rejected such a definition, as any sale of goods on credit would therefore have to be described as a form of banking. Rather the “central and distinctive” feature of banking was the fact that when a bank
receives money from a depositor it becomes a debtor of that depositor and is subject to “a superadded obligation arising out of the custom of bankers to honour the customer’s drafts” (181). This definition the court drew from a Canadian case, Attorney-General for Canada v. Attorney-General for Quebec (1947) AC. Section 51(xiii) had been modelled on section 92(15) of the Canadian Constitution. Latham CJ then listed some features of banks: they are organised as corporations, with staff, management and offices, they must have clear policies regarding deposits and drafts, and they invest their funds in order to remain a successful business. Dixon J drew upon Leaf and Sykes (1943) to give a definition of banking limited to the specific business of banks, rather than its theoretical or economic role: “a bank is a person or corporation which holds itself out to receive from the public deposits payable on demand by cheque.”

Section 51(xx) gave the Commonwealth power over financial corporations such as building societies. However, in 1909 the High Court determined that the Corporations Power was modified by s 51(i), which implicitly reserved for state governments power over trade and commerce that did not cross state or international boundaries. Testing the validity of the Australian Industries Preservation Act 1906, in Huddart Parker v Moorehead (1909) the High Court limited the scope of s 51(xx) to inter-state corporations. This had political consequences. As Galligan (1987) writes, Huddart Parker prompted the Labor Party to agitate for constitutional change, as Labor began to see the constitution and the High Court as holding back desirable reform. For their part, the states were not eager to refer their residual power over corporations under Huddart Parker to the Commonwealth because it was a “lucrative source of income” (Corcoran 1994, p. 131).

The Huddart Parker decision left the regulation of NBFIs in the hands of state governments, creating a division not only between regulatory burdens but the level of government responsible for imposing those burdens. For example, in the post-war period up to the Campbell committee, the governments of
New South Wales, Queensland, South Australia and Tasmania had the power to impose maximum interest rates on deposits or shares at call on building societies. Each state also prescribed liquidity ratios (of between 7.5 per cent and 10 per cent), reserve requirements (of between 0.5 per cent and 3.5 per cent), and gearing ratios. Furthermore, each state had a wide range of asset restrictions, from limitations on the size of the loan as a percentage of the property valuation, to limitations on lending on vacant land, and restrictions on interstate lending. Each state offered guarantees for the repayment of loans given to cooperative or terminating housing societies. Progress towards harmonisation of state regulation of NBFIs was made when the states adopted a uniform Hire Purchase Bill in 1959.

Nevertheless, as described below, the possibilities for a federal takeover of NBFI regulation offered by a High Court decision in 1971 were too appealing for the Whitlam government, the first Labor government in more than two decades, to avoid.

5.3 Banks and non-banks under financial repression

Banks were subject to much heavier regulation to that imposed on NBFIs by the states. The Banking Act 1945 imposed three major constraints on the banks. The first was the statutory reserve deposit (SRD), a variable reserve requirement which was originally introduced in the November 1941 national security regulations. The second was the liquid and government securities (LGS) ratio that had been introduced in 1953, usually fixed at 25 per cent of bank assets. The SRD and LGS ratios operated in tandem. Changes to the SRD ratio would affect lending as banks sought to keep their LGS ratio constant. The introduction of the LGS ratio to supplement the SRD was intended to reduce reliance on cooperation between the private banks and the central bank, and to compensate for the curtailing of the Commonwealth Bank’s discretionary powers over the special accounts by reforms introduced by the Menzies government’s 1953 Banking Act. Another reason for the introduction of the LGS was a recognition of the perverse
incentives that arose from the special accounts procedure. Arndt (1956, p. 249) described this as a tension between prudential and monetary policy brought about by the operation of the SRD ratio:

Since withdrawals from special accounts were legally subject to the discretionary consent of the central bank, the trading banks strictly had to regard their special account balances as a frozen, completely illiquid asset. [Yet] no Government nowadays can afford to allow the banking system to collapse ... If the central bank could be relied upon to release special account balances whenever trading bank liquidity was impaired by external deflationary influences, the trading banks could afford to treat them, to that extent, as a liquid reserve ...

The third major regulatory constraint imposed by the banking act was its controls on interest rates and assets. These restrictions had a long intellectual pedigree. The Great Depression saw much agitation from the labour movement for regulating the interest rates charged by private banks (see, for instance, McCallum 1934). Early in the depression, each state introduced legislation that forcibly reduced interest rates paid on private mortgage contracts by nearly one-quarter above five per cent (Schedvin 1973a). The Scullin government introduced legislation in March 1931 which would have established a five-person Bank Interest Board to fix the interest rates charged on deposits and advances by the Commonwealth Bank and the private trading banks. In his dissent to the 1937 Royal Commission, Chifley had written that “every effort should be made to keep interest rates low, even if legislation is necessary for this purpose” (Royal Commission into Monetary and Banking Systems 1937, p. 265) and introducing the Banking Act in 1945 had described the rate of interest as one of the “strategic points of economic activity” (CPD, House of Representatives, 9 March 1945, p. 556).

The direct controls imposed on banking encouraged the growth of alternative institutions of credit provision outside the traditional banking sector, who were able to offer depositors and borrowers better terms and interest rates that would be allowed under Commonwealth law (Schedvin 1992). Most
prominent among these were the building societies, which experienced a boom between the 1950s and 1970s, and hire-purchase firms. Each deserve a brief overview.

5.3.1 Building societies

Building societies developed in Britain in the late eighteenth century in response to social, economic and financial changes brought about by the Industrial Revolution (Boléat 1981). The earliest building society in the historical record was founded in Birmingham in 1775. These early building societies formed the basic model that was to be extended in the intervening decades. Early building societies had roughly twenty members. Members of building societies contributed an agreed sum on a fortnightly or monthly basis which the society would save until there was enough to purchase land and start building houses in groups. The order members received their houses was decided by lot or auction. Members continued paying into the building society until all members had received their houses, at which time the society would be terminated. In the first half of the nineteenth century, terminating building societies were slowly displaced by permanent building societies which developed more “bank-like” features. For example, by remaining an ongoing concern, new members could draw a loan immediately. Over the nineteenth century, building societies started to accept deposits from the general public. British immigrants brought building societies with them to Australia, and the first Australian permanent building society was established in 1850.

The history of building societies in Australia can be divided into two periods. This form of financial institution thrived in the nineteenth century, but the Depression of the 1890s devastated the building societies industry. When the Banking Act was being drafted in 1945 building societies were only a small part of the Australian financial system. However, the regulatory suppression of the trading banks gave a competitive advantage to alternative forms of housing finance, and building societies returned in force.
Where the trading banks were forced to ration their loans, building societies could expand. Interest rates offered by building societies were consistently above that offered by the trading banks until the reforms of the 1980s. Building society assets climbed from just over three per cent of financial institutions in 1953 to a peak of 8.3 per cent in 1980 (Thomson and Abbott 1998). Furthermore, building societies were starting to offer products that made them nearly indistinguishable from banks, for instance, by offering passbook accounts (Harper 1985).

5.3.2 Hire purchase firms

Hire-purchase firms filled the gap in the market for medium-term credit created by financial repression. Dubbed the “poor man’s overdraft”, hire-purchase finance is a form of “medium-term” credit (Arndt and Sharpnel 1953). Under a hire-purchase arrangement, the borrower takes possession of a good and pays for that good in instalments. During the payment period, the borrower is legally considered to be “renting” the good. Once the instalments are fully paid, the borrower owns the good. The borrower could be a company or an individual. The earliest hire-purchase financiers were the retailers that sold the good in question. In the post-war period, hire-purchase services tended to be provided by dedicated financial intermediaries; that is, hire purchase finance companies.

Hire purchase finance evolved out of informal arrangements such short term retail credit, which was common in Australia in the early 19th century. Before the First World War, recognisably hire purchase finance arrangements were primarily used for the purchase of large investment items like furniture. The earliest clear record of a hire-purchase arrangement in Australia is an account statement of a piano being sold on hire purchase in Melbourne in 1886 (van der Eng 2008). Hire purchase finance properly took off in the 1920s with the advent of cheap automobiles and electrical equipment like wireless receiver sets ('Hire-Purchase' 1954). Merrett and Ville (2011) identify hire-purchase in this period with
the growth of a consumer society. The Great Depression shrunk the size of the hire purchase market. It had only just begun to rebound in the late 1930s when capital controls were introduced (Schedvin 1992). Hire-purchase grew rapidly in the first post-war decades when it was typically used to finance the purchase of large consumer durables and cars (McKee 1960; Runcie 1969). The cultural effect of hire purchase was significant. The idea of buying goods on credit has been described as a “minor social revolution” in Australia (Donovan 1958, p. 668).

Motor cars and household equipment, which became available after the shortages of the war, were almost irresistible when they could be purchased out of current income rather than out of savings, by means of time payments. In recent years the television set, the motor boat, and the power lawn mower have exercised the same attraction. And in Australia, as in other countries, once the habit of using credit has been established, consumers finance not only their TV sets but also their home improvements and even their travels without saving beforehand (Myers 1961).

The Commonwealth Bank had exempted hire-purchase firms from its determinations of what constitutes a bank for the purpose of the Banking Act in 1946. In 1950, one hire purchase finance company, the Industrial Acceptance Corporation, received Commonwealth Bank approval to raise funds at about one percentage point higher than the controlled bank rates. As Schedvin (1992, p. 222) writes, “This was a revolutionary moment in the history of Australian finance. A new instrument outside the control of the authorities had been developed; persistent innovation along these lines was in time to undermine the foundations of the regulatory structure.”

This ability to raise funds above the regulated rates of the banks gave hire purchase finance much of its competitive power. By 1957 all the major banks had either introduced hire purchase subsidiaries or taken majority shares in hire purchase companies. Between 1945 and 1960 hire purchase grew from 2.5 per cent of the total advances of all cheque-paying banks, to 54.7 per cent (Runcie and Burke 1969).
Taken together with other institutions like co-operative societies, merchant banks, pastoral finance companies and money market dealers, the NBFI sector was cleaving away a larger and larger proportion of the credit market from traditional banks (Coombs 1958). More than 1,500 finance companies serviced Australian borrowers by 1960 (van der Eng 2008).

5.3.3 Pressure to regulate

Pressure to extend direct Commonwealth control onto NBFIs came from two sources. The first was the Labor Party. Labor voters tended to use hire purchase more than conservative voters (Murphy 2000). Throughout the 1950s and 1960s Labor in opposition had complained that the Menzies government had done nothing to constrain the activities of hire-purchase companies by regulating their interest rates. Arthur Calwell described hire-purchase as a form of “black market banking” (The Age, 20 August 1958, p. 5) and accused trading banks moving into the hire purchase industry as “fleecing the public” with their higher interest rates (The Age, 17 October 1960, p. 6). Surveys in the mid-1950s demonstrated mixed views about hire-purchase; while 53 per cent of respondents thought hire purchase was “a good thing for the average Australian”, 42 per cent disapproved (Gordon 1961).

The second push for regulating NBFIs came from theorists and practitioners of monetary policy. In the immediate post-war period control over hire-purchase was exercised through capital controls on regulated banks that allowed the Commonwealth Bank to choke off finance as it desired. From a monetary perspective, the effects of these controls were unpredictable (Hogan 1958). The shrinking share of the trading banks contribution to credit creation meant that the monetary instruments which worked through bank regulation – the SRD and LGS ratios - were increasingly ineffective (Argy 1960). Gurley and Shaw (1960) argued that the presence in a monetary system of NBFIs could frustrate central
bank monetary control by making the velocity of money more volatile (see also Gurley and Shaw 1955; Hogan 1960).

For his part, the governor of the Commonwealth Bank H.C. Coombs (1958) worried that Australian monetary policy was “operating in a steadily contracting field”. Coombs commissioned three legal opinions in the 1950s seeking advice as to whether the Commonwealth Bank could regulate hire purchase firms as banks. However, the most persuasive of the three saw hire purchase as distinct from the fundamental business of banking - the use of deposits payable on demand to provision loans - and as a consequence Coombs did not pursue any direct control on hire-purchase during his term as governor (Schedvin 1992).

Monetary authorities were aware of an alternative to direct controls. Aschheim (1959) argued that monetary policy should be pursued through open market operations rather than direct regulation of specific financial intermediaries. However, unlike the larger economies of the United States and United Kingdom, Australia lacked a money market where the central bank could exercise open market operations as a monetary tool. An attempt to issue Treasury bills in 1936 had been embarrassingly unsubscribed. The 1937 Royal Commission had concluded that while open market operations were a desirable tool of monetary policy, the narrowness of the Australian government securities market was too narrow for such operations to be effective.

The late 1950s saw a return of momentum towards the establishment of an official money market. Of the arguments in favour of an official short term money market within the Commonwealth Bank, the most compelling was that an official money market would be a tool for policy (Schedvin 1992). However the Commonwealth Bank’s hand was forced by the development of a private market for commercial and Treasury bills. The central bank formed the view that as an expanded money market was inevitable,
giving it an official status would guarantee the Commonwealth Bank’s continued influence over the market. Private dealers sought Commonwealth Bank involvement because it was believed that a money market of any scale would require a central bank to offer lender of last resort facilities. Money market dealers were vulnerable to liquidity problems if hit by an unusual pattern of withdrawals (Hogan 1959). The Commonwealth Bank announced the provision of the lender of last resort in February 1959 for an official money market. The official market was strictly regulated. Only authorised dealers had access to the central bank’s discount window. When the money market opened there were only four dealers authorised. By 1960 that number had expanded to nine.

The development of the official short-term money market represents a major change in philosophy by the Commonwealth Bank and policy-makers. Attitudes changed from the centralisation and control of the war to greater sympathy with markets, moving further along the IPF towards greater market control. Nevertheless, the pace of change was glacial. The money market was tightly regulated and managed for the purpose of providing a safe and protected market for government securities. As a direct consequence of the regulatory controls, the money market was split in two: while the official money market was regulated by the Commonwealth Bank, an unofficial money market operated outside the central bank’s jurisdiction (Hirst 1964).

5.4 The Financial Corporations Act 1974
By the time the Whitlam government came to power, traditional Labor concerns with low interest rates had been complemented by new ideological and economic interests. Gough Whitlam’s ascension to the Labor leadership in February 1967 represented a break from the Labor Party of Curtin and Chifley. As Deputy Leader he had deliberately distanced himself from Labor’s past battles, arguing that “We may not be able to nationalise the banks, but we can act in other fields. They are far more important today than banking, which is controlled more than any other form of business” (The Sydney Morning Herald,
One of these was the NBFI sector. The Labor Party’s 1972 platform stated that “hire purchase, fringe banking and other credit creating institutions” ought to be regulated “in order to control effective demand” (Taylor 1975).

Labor’s belief in regulating consumer interest rates converged with the rising economic nationalism being expressed by both sides of politics (Pokarier 2000). Labor’s policy regarding NBFI s was particularly focused on the perception that NBFI s were predominately foreign owned (Whitlam 1985). Early in its term, the new Whitlam government announced that it was its desire that there be no new foreign non-bank financial institutions established in Australia. Treasurer Frank Crean told an audience that “Australia is already adequately supplied with non-bank financial institutions and that, generally, there would be little benefit in allowing additional institutions to be established by foreign interests” (Crean 1974). In a Cabinet submission in November 1973, Crean blamed foreign ownership for the changing structure of the financial sector and declining share of banks in the financial system:

> A good deal of the growth of non-bank financial institutions in recent years can be attributed to the entry of foreign institutions ... As a general objective, I believe we should aim to prevent further increases in foreign ownership and control in this sector and, where possible, to reduce it. (NAA A5915 735).

For supporters of hire-purchase regulation, Whitlam’s 1972 election victory came at a fortunate time. An opportunity to regulate NBFI s had opened up the year before by a High Court case Strickland v Rocla Concrete Pipes Ltd (1971) 124 CLR 468. The question at hand in Concrete Pipes was whether the Commonwealth Trade Practices Act 1965-69 could constitutionally regulate restrictive business practices even if those businesses operated on an intra- rather than inter-state basis. The Court found that s51(xx) gave the Commonwealth a power to regulate restrictive practices irrespective of whether they traded across state borders or not. The High Court was reluctant to draw any further conclusions
other than those which went to the validity of the Trade Practices Act. Nevertheless, *Concrete Pipes* reversed the 1909 decision in *Huddart Parker* of ss1(xx) of the Australian constitution that construed the Commonwealth’s power to make laws about corporations as only those corporations that traded outside a state boundary, and forcefully affirmed the end of the reserved state powers doctrine. The significance of the *Concrete Pipes* case for financial regulation was not lost on the Labor Party. *Concrete Pipes* seemed to open the door to control financial institutions that had always been governed by the states (CPD, House of Representatives, 3 November 1971, p. 2899).

In April 1974 the Whitlam government introduced the Financial Corporations Bill 1974 to the House of Representatives.² The bill represented a federal takeover of NBFI regulation, covering hire-purchase finance companies, merchant banks, authorised money market dealers, permanent building societies and pastoral finance companies. The RBA was concerned it lacked accurate information about the size of the industry (Blain 1974; Crean 1974). Thus under the bill the RBA was to establish an official register of NBFI s, and registered firms were required to furnish statistics to the central bank.

However, the real significance of the Financial Corporations Act was Part IV. This part was to play a major role in the subsequent history of financial regulation in Australia. Part IV was aimed at imposing the financial repression on NBFI s that until then had been restricted to banks under the Banking Act. First, it gave the RBA power to impose minimum asset ratios on individual firms or classes of firms. This was likely to have been intended to impose some sort of LGS ratio on NBFI s (Taylor 1975). Second, it gave the RBA power to control lending policies. After amendments, the Senate intended this power to

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² A previous bill, the Financial Corporations Bill 1973, had been introduced December the year earlier but withdrawn. The differences between the two were not significant.
be used to direct finance towards housing. Third, it gave the RBA power to control interest rates offered by NBFIs.

Crean was asked in the parliamentary debate to provide academic literature in support of Part IV, which he responded to on notice (CPD, House of Representatives, 23 August 1974, p. 1180). By doing so he offered an interesting window into the role of academic literature in policy justification. The studies he referred to were Clayton (1962), Goldsmith (1958) Gurley and Shaw (1955, 1960), Hogan (1960), Patinkin (1961), Smith (1959), Tobin and Brainard (1962), Reserve Bank of Australia (1965), as well as a RBA bibliography (Bourke 1971) for further resources. However, this body of literature was a decade old, and reflected the practice of central banking in Australia and overseas as it was conducted in the late 1950s, rather than the early 1970s. Gurley and Shaw (1960) argued that money is merely one type of asset in the broader group of financial assets. Whereas the conventional doctrine at the time suggested financial intermediaries functioned merely as middle-men in a financial system, Gurley and Shaw believed they should be seen as having more similarities with banks than differences – both banks and intermediaries offer substitutable services. Central banks had chosen to conduct monetary policy through the banking system, in part because under a regulated banking system banks are smaller than they would be in equilibrium and therefore sensitive to both monetary ease and tightening. They argued the presence in a monetary system of NBFIs could frustrate central bank monetary control by making the velocity of money more volatile.

However, it was a large leap from the observation that many financial products are substitutable to specific policy recommendations. Crean had noted that “Many of the major theoretical works relating to the activities of non-bank financial intermediaries are concerned with showing the ways in which these activities can influence monetary and economic conditions rather than exploring the practical policy
implications”. Rather, he believed, “a recommendation that direct controls should be extended to non-bank financial institutions is implicit in a number of works” (CPD, House of Representatives, 23 August 1974, p. 1180). Yet many of these papers rejected the application of direct controls. For instance, Hogan (1960) argued that banks were disproportionately carrying the burden of monetary policy, yet pointed out that even if it was constitutionally possible to extend direct controls onto NBFIs, it would be undesirable to do so as “it would not be long before new financial organizations were developed outside the sphere of monetary authorities” (Hogan 1960, p. 529). Smith (1959, p. 533) rejected the suggestion that monetary policy had been significantly harmed by NBFIs: “while the growth of these institutions has weakened monetary controls to some extent, the effects do not appear to have been very great, and the main sources of difficulty for monetary policy are to be found elsewhere.” Nevertheless, Smith did speculate that NBFIs could be regulated on the grounds of equity – that is, to balance the impact of monetary controls across the financial sector – or if certain non-bank institutional forms were found to be ‘sensitive spots’ in the economy.

By the ascension of the Whitlam government, the wisdom on control of NBFIs for monetary policy purpose had evolved substantially. In the 1950s Coombs had been concerned about the effect NBFIs growth would have on monetary policy (Coombs 1958). Yet a decade later the RBA was beginning to favour the transmission of monetary policy through the money market. The RBA’s Banking and Finance Department chief, D.N. Sanders, told a conference in 1969 that:

I favour action through the market, rather than direct restraints to achieve the objectives of monetary policy ... the competitive pressures within and on the fringes of these groups are strong. The lines of monetary policy are most impressive to them when they are reflected in the market place. (Taylor 1975, p. 17)
This increasing reliance on open market operations was reflected in Arndt and Stammer (1973), the standard textbook on Australian banking at the time the Financial Corporations Bill was being debated in parliament.

In this changed intellectual context, opposition to the Financial Corporations Bill came from both within the government and without. Throughout the 1970s the RBA expressed a private antipathy towards excessively stringent controls on NBFIs (Cashion 1977). Schedvin (1992, p. 499) writes that while the RBA cooperated with the government in drafting the Financial Corporations Bill, it did so “with a total lack of conviction”. The RBA believed Part IV would be a reserve power that would be used only if there was a demonstrated need, and a stick with which to threaten uncooperative NBFIs. The bill was more aggressively opposed by the NBFI sector. Opposition came from finance companies, merchant banks, authorised money market dealers, permanent building societies and pastoral finance companies, who objected that the interest limitations would constrain credit and that the federal takeover was possibly unconstitutional (Taylor 1975). The only supporters in the NBFI sector came from the Australian Federation of Credit Unions League, who argued that the proposed controls would have little impact on their operations as they already had a restrictive lending policy, high levels of reserves, and low interest rates.

By contrast, the reaction of trading banks to the Financial Corporations Bill ranged between ambivalence and outright support. NBFIs had taken market share from the trading banks. Some NBFIs, such as merchant banks, operated in lucrative markets that the banks were prevented from entering. Others were starting to offer substitutes for products traditionally offered by the banks (Harper 1985). As one ANZ economist recalled about the debate within the banking sector as to the desirability of NBFI controls:
There were huge variances of opinion between senior bankers as to whether we should even be talking about deregulation. I mean, this was a cosy industry, where you made a lot of money out of being protected, where the government set the rate at which you could borrow funds and lend funds, and anything you did to spend the margin in between just decreased your profitability.

(Fitzgibbons 2006, p. 5)

As late as 1978, a paper produced by the ANZ for the ABA proposed two directions for regulatory reform: deregulation of banks or Commonwealth regulation of NBFIs. The ANZ and ABA preferred the latter (Pauly 1987). One ABA economist of the period described the prevailing views this way:

There was always this bit of ambivalence on behalf of the banks: did they want less regulation for the banks, or did they want more regulation for the unregulated sector? ... The banking industry was very split ... (Fitzgibbons 2006, p. 8)

In the event, the Financial Corporations Bill passed parliament with the support of the Liberal-Country Coalition in August 1974. Parts I, II and V came into operation immediately. However, the bill stipulated that other parts would come into effect at the discretion of the government. Two months later the government decided to bring into effect Part III, which required the newly registered financial corporations to provide statistics to the RBA, and that part was subsequently proclaimed into law by the Governor-General. However the Whitlam government did not enact Part IV, which extended the RBA controls onto NBFIs, and as a consequence Part IV was not proclaimed into law.

Why wasn’t Part IV proclaimed? Treasury believed that the mere existence of the unproclaimed Part IV would give the government a moral suasion power over the sector nevertheless (Pauly 1987). The RBA by contrast did not feel that suasion would do much more than encourage marginal changes to NBFI practice (RBA Archives RD-NS-179). The peak finance industry body, the Australian Financial Conference, had successfully lobbied to introduce two clauses in the bill (30 and 31) which allowed the RBA to
consult with the finance industry in relation to the use of its powers (Taylor 1975). While these provisions may seem minor – they did not compel consultation, but merely allowed it – their existence buttresses the view Part IV was intended as a tool to be wielded as a threat to gain “voluntary” cooperation from NBFIs if circumstances arose. As a later Fraser government Cabinet document explained,

There have been many assurances by this and the previous Government – when the Act was first under consideration by the previous Government, in the introduction of the Bill to Parliament, and subsequently through the Advisory Committees – that there would be consultation with the finance groups before any recourse were had to control powers. The thrust of these assurances has been that Part IV is considered by the Government as a reserve power which would only be used should existing policy possibilities prove inadequate. (NAA A12909 1770)

Lingering uncertainty as to the implications of Concrete Pipes also meant the Whitlam government was not sure Part IV would survive a High Court challenge if the Commonwealth decided to take an active regulatory role. The upshot was that Part IV sat on the statute books waiting for proclamation by a future government. The existence of the unproclaimed legislation created a political problem for the Fraser government when it faced the largest building society crisis in eighty years.

5.5 The building society crisis
After the relative inflationary calm of the 1950s and 1960s, the first years of the Whitlam government coincided with a sharp increase in consumer price inflation. Between late 1971 and 1973 monetary policy was relatively expansionary. In the second half of 1973, however, this stance was sharply reversed, and the Australian economy experienced six straight quarters of restraint in monetary policy. The handbrake-like swing in monetary policy was also combined with a number of other substantive
economic policy changes, including the Whitlam government’s 25 per cent tariff cut in the third quarter of 1973 (Rowan 1980, p. 206).

The housing and construction sector bore the full brunt of the change in monetary policy, sparking a building society crisis that was experienced in waves throughout the 1970s. The first wave struck in late 1974. In July that year, as parliament was considering the Financial Corporations Act, Home Units Australia collapsed, followed by Mainline Australia, and, in October 1974, the Cambridge Credit Corporation. Cambridge was the largest property firm in Australia and its failure sparked an immediate run on a series of building societies in Victoria, Queensland and South Australia. Sykes (1988, p. 467) has described the failure of Cambridge as “the blackest day on Australian stock exchanges of the twentieth century”.

The most dramatic spillover was the run against the 96-year old Hindmarsh Building Society. The run on the Hindmarsh has become the classic example of a bank run in Australia (Lewis 1997a; Mann et al. 1976). By all accounts the Hindmarsh was well managed. It had no exposure to Cambridge Credit, nor was it exposed to other property firm that was known to be in financial trouble. Yet the announcement of the failure of Cambridge on Tuesday 1 October 1974 led to a run on the Hindmarsh. By Friday 4 October, $10 million had been withdrawn from Hindmarsh. This run was stubbornly resistant to the many attempts by policymakers to ease the panic. Newspaper announcements of the Cambridge collapse on 1 October included a statement by the acting Federal Treasurer Bill Hayden that “the government was ready to act if the general financial situation warranted it” (Sydney Morning Herald, 1 October 1974, p. 1). On Wednesday 2 October Hayden was quoted saying that the RBA was willing to shore up “responsibly managed” institutions (Australian Financial Review, 3 October 1974, p. 1). The next day, ‘Black Thursday’, was the worst day of the run. The South Australian Premier Don Dunstan
attempted a dramatic personal intervention by standing outside the Hindmarsh with a megaphone declaring it safe (Sykes 1988). Neither the RBA’s or Dunstan’s interventions were able to halt the run, which only subsided over the weekend. In among this drama, the events at the Hindmarsh illustrated the ad hoc and uncertain policy approach to financial institution failures of the mid-1970s.

A second wave of crisis occurred in March 1976, when the Queensland government was forced to suspend six building societies after they suffered another run. The Fraser government treasurer Phillip Lynch pledged the support of the Reserve Bank to act as lender of last resort if necessary. The Queensland government arranged the amalgamation of the suspended societies backed by support from the State Government Insurance Office, creating the SGIO Building Society, thereafter the third largest building society in the state. In April 1976, the Queensland government amended its building societies legislation to limit the forms of investments building societies could make and increase the ability of state auditors to examine the operations of any building society (Beale 1984).

Of all the building societies affected by the property bust of the mid-1970s, the Queensland Permanent Building Society (QPBS) had the most long-term significance. The collapse of the QPBS set off a train of events leading to the Campbell committee, and shaping subsequent reform. The QPBS was the second-largest building society in Queensland. It was severely affected by the October 1974 crisis. This came at a terrible time for the QPBS as it had only two weeks earlier finished installing a new computer system and consequently struggled with the flood of withdrawals during the panic. The QPBS had not adequately trained its staff in the system and had installed inadequate backup (Touche Ross & Co. 1978). The QPBS recovered from the 1974 run but the chaos of the run combined with poor record management and accounting procedures meant its accounts were never reconciled. Nevertheless, it survived the March 1976 building societies crisis and, rather than consolidating its operations, took over
a number of other struggling building societies. It acquired the Gold Coast Permanent Building Society without properly auditing the society’s financials, which were, it was later to discover, dire. Similar problems were found with another acquisition, the Sunstate Permanent Building Society. “One of the great mysteries of Queensland’s financial history is how the board apparently managed to remain ignorant of this situation for two years” (Sykes 1988, p. 476).

The final straw for QPBS came from the Queensland parliament. On 30 August 1977 Labor’s state opposition spokesperson for housing, Kevin Hooper, launched a furious attack on the management of the QPBS, describing it as a “cancer” on the industry, its managing director as “hopelessly incompetent”, and its public reporting as “meaningless nonsense”. Hooper advised that “if anyone in this Chamber has money in the Queensland Permanent, he should get it out as quickly as possible, because this society is definitely on the rocks” (QPD, Legislative Assembly, 30 August 1976, p. 241). Hooper’s attack sparked a sudden run on the society which was initially severe but subsidised. However, over the next month $18 million flowed out of the doors of the QPBS. At 5:30am on 28 September the board of the QPBS released a statement that a liquidator had been appointed. While the Coalition government attempted to lay blame for the collapse on the opposition housing spokesman, the Treasurer also told the parliament that “Everyone knows that the Queensland Permanent Building Society has been carrying forward an unidentified loss totalling $3,800,000 for several years” (QPD, Legislative Assembly, 28 September 1977, 974).

5.5.1 Federal consequences of the QPBS collapse

These building society crises directed political attention towards the Financial Corporations Act and the still unproclaimed Part IV. Cabinet records in 1977 and 1978 reveal a debate within the senior levels of the Fraser government not only over the proclamation of Part IV but about the
direction of Australian political economy in general. If the Campbell Committee set the course of financial regulation for the next two decades, then it was these Cabinet meetings that were the turning point. The records show a government deeply divided about the economic philosophy that ought to be adopted into the future.

The day after Queensland suspended the five building societies in March 1976, Whitlam, now opposition leader, had asked the Treasurer Phillip Lynch:

How soon will he be able to reassure investors in permanent building societies by action available to his Government, namely to proclaim the part of the Financial Corporations Act 1974 which covers the regulation and control of business and financial corporations, and make regulations specifying the asset ratios, lending policies and interest rates of permanent building societies? (CPD, House of Representatives, 18 March 1976, p. 771)

To which Lynch responded that the Financial Corporations Act “was designed for purposes of overall economic management and not the financial stability of particular institutions. This, as the honourable gentleman ought well to understand, is clearly reflected in the provisions contained in the Act” (CPD, House of Representatives, 18 March 1976, p. 772). After the QPBS collapsed eighteen months later, Whitlam again pressed the government on why Part IV had not been proclaimed (CPD, House of Representatives, 26 October 1977, p. 2387-88).

There were two prevailing views about the purpose and significance of Part IV. Whitlam saw Part IV as a form of prudential regulation. In his view, with the powers enumerated in Part IV, the RBA would be able to manage, scrutinise and ultimately regulate the affairs of individual NBFIs. Had such regulation been enacted, it would have prevented the afflicted building societies from acting imprudently. Whitlam was protesting parliament’s failure to proclaim Part IV well into the 1990s (Martin 1999; Whitlam 1992).
Lynch, by contrast, argued that even if Part IV was proclaimed, the act was primarily a mechanism for macroeconomic management rather than prudential control. However, the difference between these two positions in the 1970s ought not to be overstated. Taylor (1975, p. 15) argues that had the Coalition been in government between 1972 and 1975 is likely that it would have introduced similar legislation itself, with similar provisions. And when Lynch supported the bill in parliament in 1974, he had done so “for the purpose of monetary policy and they can be used to protect investors where the financial security of their investments might be jeopardised … I believe that as a matter of equity the Government ought also have the power to impose direct controls over the non-bank sector” (CPD, House of Representatives, 23 July 1974, p. 501).

Whether to proclaim Part IV in the wake of the QPBS collapse was a live question within the Fraser government. Following a request from the Queensland treasurer, the RBA had once again pledged to provide liquidity support if necessary (NAA A12909 1719). But the Fraser government felt the need for firmer and more direct action. Six days after the QPBS closed its doors, an ad hoc Cabinet committee heard an oral report from the treasurer Phillip Lynch outlining the specifics of the collapse and some proposals for federal intervention. Unfortunately, we do not have a written record of these proposals. Nevertheless, the committee commissioned a report from the Treasury and the Reserve Bank “as to the reason the Government had so little warning of the matter and why the relevant section of the Financial Corporations Act has not been proclaimed” (NAA A13075 3984/AD HOC).

Lynch brought a joint submission from the Treasury and the RBA to a full Cabinet meeting on 11 October (NAA A12909 1719). That submission declared forcefully that the Financial Corporations Act “was intentionally not formulated with the object of providing a means for protecting investors or the financial stability of individual societies”. In the view of the Treasury and the RBA, Part IV was designed
“primarily to enhance the scope of monetary policy”, and that, as was suggested by the RBA at the time of passage, “the requirements of monetary policy have not been such as to require Part IV to be proclaimed”. The submission also noted that the Queensland government might be expected to be jealous of any federal encroachment on what was a long-standing area of state constitutional jurisdiction. Nevertheless, the Cabinet requested the Treasurer bring forward bringing submissions concerning both the possible proclamation of Part IV “in support of the Government’s monetary policy” (NAA A13075 4037) and a further submission “containing definite proposals for ensuring the financial viability and stability of permanent building societies and similar institutions” (NAA A12909 1719). What was originally a crisis meeting of an ad hoc Cabinet committee was evolving into something more general, investigating the mechanics of monetary policy and addressing broader questions about financial stability.

Some in Cabinet were not convinced by the Treasury and RBA submission rejecting the proclamation of Part IV. In his memoirs John Howard (2010), who took over the Treasury portfolio a month later, names Malcolm Fraser as one of those who was eager to proclaim Part IV in the wake of the crisis. The government’s equivocation spilled out into the media. The *Sydney Morning Herald* (16 October 1977, p. 2) and *The Age* (17 October 1977, p. 18) reported cited “government sources” claiming that Lynch was either considering or intending to proclaim the controversial section in order to prevent future financial collapses. Yet Lynch had privately informed the NBFI sector that Part IV “would not be used for financial stability purposes” (NAA A12909 1719). Treasury and the RBA were skittish about even signalling the possible proclamation of Part IV because of the negative effect doing so could have on capital markets (NAA A12909 1770).
Lynch brought the two interim submissions requested in October to the full Cabinet on 3 and 4 November (NAA A12909 1771; NAA A12909 1770). To protect the financial stability of building societies, four options were raised for Commonwealth involvement: the status quo (in which the RBA continued to provide liquidity), a National Building Societies Act, the proclamation of Part IV of the Financial Corporations Act, or the introduction of a deposit insurance scheme for building societies. All but the status quo would have represented Commonwealth intervention into the NBFI sector. One of the major concerns raised in the Cabinet submissions to the reform options was that they could imbalance the financial system. The government could not simply act on building society stability without facing demands that protect the stability of other NFIs, such as credit unions. Furthermore, the Treasurer had hardened against the proclamation of Part IV:

Part IV regulations could mean fundamental changes in the works of financial markets and for the operation of monetary policy. It could involve, by way of new direct interventions, substantial changes to the pattern of financing – both in terms of funds flows and costs. These changes would not necessarily be smooth even with the most careful attention to the preparation and introduction of the regulations. Moreover, as with all controls, those subject to them are well aware that they open the way to arbitrariness and consequent inefficiencies. (NAA A12909 1770)

Such criticisms were couched in a concern about the pace of change and the impact that would have on markets. However here we see the first pressures to expand the government’s attention to the financial system more broadly. Treasury and the RBA, through Lynch, were using the internal debate over Part IV to agitate for broader concerns on financial efficiency and the regulatory framework governing the financial sector as a whole. The political pressure created by the collapse of QPBS set in train a course of events that would, eight years later, lead to the introduction of foreign banks into the Australian market.
5.6 Conclusion

The Financial Corporations Act can be seen as an antipodean analogue of the Calomiris and Haber (2014) banker-populist coalition, as privately-interested bankers cooperate with populist politicians seeking to deliver rents to their supporters. On the populist side, the Financial Corporations Act has to be seen as the apogee - if an uncertain and unfinished one - of the long-standing desire of the Labor Party to deliver regulated rates to its supporters, enabled by the institutional change of the Concrete Pipes case. At the state level, Labor, acting in concert with the Country Party, sought to impose ceilings on hire purchase interest rates. Federally, the ALP maintained its intention to influence the activities of NBFIs - particularly focused on hire purchase firms - throughout the 1950s and 1960s.

Support for the regulation of NBFIs also came from trading banks chafing under the restraints of the Banking Act. While trading banks had established NBFI affiliates throughout the post-war years it remained the case that NBFIs, particularly building societies, were attracting depositors away from banks with their higher interest rates. Building societies were offering bank-like products and directly competing with the established trading banks. This chapter has explored the debate within the trading banks themselves as to whether the appropriate resolution of this problem was to advocate the reduction of regulation on banking or increase regulation on NBFIs to level the playing field. Thus it is possible to tell a private interest story about the Financial Corporations Act, as a partially successful attempt by private banks to impose regulation on their more nimble, less regulated and more entrepreneurial competitors.

By contrast, outlining a public interest explanation for the Financial Corporations Act illustrates the challenge of analysing public interest motivations without an integration of ideas and ideology. While Crean emphasised the monetary policy considerations for the regulation of NBFIs, the literature which he referred to in the parliamentary debate offered little support for such an approach. It was true that
the literature after Gurley and Shaw (1960) had emphasised the substitutability of the services provided by banks and NBFIs. The policy conclusions drawn from that theoretical finding were not however obvious. The RBA had already responded to changes in the financial sector by conducting monetary policy through open market operations, a mechanism made possible by the establishment of the official money market in 1959. To this extent, as an attempt to facilitate monetary policy, the Financial Corporations Act was a decade or more out of date when it was introduced.

Of course, the transmission of ideas from scholarship to parliament is not costless. It takes time for views aired in academic literature to be converted into legislation. And that transmission involves ‘loss’ as well. Bismarck’s famous adage compared the process of making laws to making sausages; the original material of both has been completely transformed by the time it reaches its end product. It would not be reasonable to complain that did Crean did not perfectly represent the literature he cited in his parliamentary debate. Even the finest meat has to be ground, compressed, and encased before it can be considered a sausage. Even the most neutral, publicly interested, Pareto-improving policy proposal has to navigate private and political interests before it can assume a form possible to pass through parliament. But this observation only emphasises the weaknesses in the public interest model of regulation and regulatory change.

The Financial Corporations Act assumed its form not because of a dispassionate assessment of the post-Gurley and Shaw (1960) literature but because of Labor’s long standing desire to regulate financial corporations at the Commonwealth level and a political belief that monetary policy was being made ineffective due to the growth of NBFIs. Further pressures came from banks losing market share to NBFIs, and the institutional opportunity opened up by the Concrete Pipes case. The narrative of this chapter describes a clash of perceived disorder costs and dictatorship costs. On the one hand the Labor Party
and many private banks saw the disorder costs of regulatory arbitrage as inefficient. On the other hand, the RBA believed that the dictatorship costs of direct interest rate control were unnecessarily high given institutional changes that meant open market monetary operations were possible. The bargaining between these two positions led to the unproclaimed Part IV, which each side saw as relatively inefficient compared to their ideal institutional setting but less so than the pre-Whitlam status quo.

The long term consequences of the Financial Corporations Act were substantial. When building societies failed under the Fraser government the unproclaimed Part IV created a political environment where the government had to respond. The crisis sharply raised the perceived disorder costs of the 1974 institutional bargain. The nature of the Fraser government’s response, and how pressure to increase regulation on NBFIs eventually became a broad program of regulatory reform, is the subject of the next chapter.
6 THE CAMPBELL COMMITTEE AND THE MARTIN GROUP REPORT

6.1 Introduction¹

Between the 1977 election and the release of the Campbell committee report in September 1981, the Campbell committee became a sink into which the Fraser government threw all manner of policy issues for consideration. Cabinet records demonstrate the intertwining policy decisions which flowed into the committee process, and this helps us understand why the report ultimately took its final shape and was so politically challenging when it was released. Much debate around the Campbell committee concerns which policy actor can take the credit for its establishment, or who deserves the blame for its delay in implementation under the Fraser government (Ayres 1987; Errington and Van Onselen 2007; Fraser and Simons 2010; Howard 2010; Wallace 1993; Weller 1989). This chapter looks at the political and intellectual factors which informed the Campbell committee report and its successor, the Martin Group report, which was commissioned by the Hawke government to reconsider financial reform through Labor’s ideological framework.

It was commented at the time that the Campbell committee’s approach to prudential regulation was noteworthy for its intellectual weakness and apparent inconsistency with the rest of the report (Hogan and Sharpe 1983; Swan 1983; Valentine 1983). This chapter provides a possible explanation for that weakness: the parallel consideration of a Commonwealth backed building society deposit insurance scheme, separate to the Campbell committee process. If it was the building society failures of 1977 which led to the promise and establishment of a broad-based capital market inquiry, the irony is that prudential issues were under-examined by that inquiry precisely because the political promises made in 1977 regarding deposit insurance were impossible to delay until the finalisation of the report. The

¹ Parts of this chapter have been published in Berg, C 2016, 'The Campbell committee and the origins of ‘deregulation’ in Australia', Australian Journal of Political Science, viewed 29 August 2016, <http://dx.doi.org/10.1080/10361146.2016.1219315>.
Campbell committee’s principle of competitive neutrality – which counselled that financial services which competed against each other should face the same burden of regulation - was constrained by a parallel Fraser government promise that a building society deposit insurance scheme would be established in the wake of the building society crisis of the mid-1970s.

The Campbell committee is an example of path dependency in legislative and political decision-making that can fix the long term trajectory of any given regulatory framework. Such an analysis makes the short-term political context of reform decisions of more than incidental historical interest. Shadows of the political reaction to the 1970s building society crisis determined the shape of the Campbell committee’s final report, the approach to prudential regulation during the 1980s, and even the determinations of the Wallis Financial System Inquiry in the first years of the Howard government.

The chapter first outlines the political process which led to the establishment of the Campbell committee. The narrowness of the controversy about the Campbell committee’s origins since the public release of Fraser government Cabinet records - the 1977 records were released in 2008 - has meant that no fuller consideration of the political influences on the Campbell committee has been completed. The chapter then considers the release of the final report of the Campbell committee and its approach to prudential policy more closely in light of those political decisions. Finally, it looks at how the newly elected Hawke government took the principles established in the Campbell committee, filtered them through a different ideological lens, and released them with bare modification in the Martin Group Report.

6.2 The establishment of the Campbell Committee
Malcolm Fraser’s government was a transitional government, in which the post-war economic consensus over Keynesian demand management, heavy regulatory interventionism, and full
employment had broken down but the establishment of a new orthodoxy of market liberalisation and safety-net social welfare had not yet taken its place. The Fraser government described itself as “private enterprise” but Fraser himself believed “less in the free market, having learnt his liberalism in a protectionist age, when it was believed that government can do a lot of things that it is now recognised government better leaves alone” (Kemp 2015). It was under the Fraser government that the ‘Dry’ movement within the Liberal Party developed, which sought much more radical and comprehensive market-based economic reform than Fraser was willing to pursue (Berg 2015a; Hyde 2002). The story of the Campbell committee is in part the story of that tension between a group of Liberal Party ministers who had sympathy for the post-war consensus and another group of ministers and backbenchers who were pushing more radical change.

The idea of an inquiry into the Australian financial system had been on the cards for some years before the Fraser Cabinet gave the go-ahead for the formation of the Campbell committee. In his policy speech delivered for the 1975 federal election, Malcolm Fraser announced that an elected Coalition government would conduct “a comprehensive examination of ways in which the efficiency of the Australian capital market can be improved with special reference to the availability of finance for the expansion of small business investment” (Fraser 1975). Fraser was mostly concerned about small business finance rather than the financial sector as a whole (Fraser and Simons 2010; Harper 1985). His government did not follow up this pledge in its first term.

Nevertheless the conjunction of an election campaign and a building society crisis gave spur to action. Fraser called the election on 27 October 1977 - less than one month after the collapse of the QPBS. Building societies were top of the political agenda. Labor had led its parliamentary attack on the government the previous day by claiming the federal government had neglected building societies by
failing to proclaim Part IV (CPD, House of Representatives, 26 October 1977, p. 2387-88). Federal Cabinet was still considering the policy response to the building society crisis right up to the issue of election writs and the start of caretaker conventions on November 10. The Cabinet decisions described in this chapter ought to be seen in the context of external political pressure in the lead-up to an election.

Sometime between the collapse of QPBS and 3 November 1977 the former Liberal Prime Minister William McMahon suggested to Malcolm Fraser that the government facilitate the creation of a deposit insurance scheme for building societies (NAA A12909 1770). Since the 1974 building society panic, the Australian Association of Permanent Building Societies (AAPBS) had been lobbying the government for a government-sponsored deposit insurance scheme (RBA Archives RD-NS-179). A deposits insurance scheme was one of the range of options brought to Cabinet by Lynch on 3 December but it was given an extra impetus by the Prime Minister’s personal support. Cabinet considered an interim submission from the Prime Minister the next day briefly outlining the case for such a scheme:

There is a need for the Government to ensure it is able to impose some minimum supervisory, financial management requirements on the building society movement. An inexpensive method of achieving this, in terms of minimal financial cost, and maximum acceptance by the building society movement, State Governments and the public, is a deposits insurance scheme (NAA A12909 1823)

The submission also noted that the insurance scheme need not be limited to building societies: “Other deposits-taking financial institutions could be catered for, and premiums adjusted to reflect the volatility and risk of the institutions and nature of depositors involved” (NAA A12909 1823). Three days later an ad hoc Cabinet committee considered a follow up submission (NAA A12933 195). The proposal on the table was a Commonwealth government run deposit insurance scheme with voluntary participation, with an initial repayable capital contribution from the budget:
A well-conceived well implemented scheme of deposits insurance could in theory prevent - or at least minimise - ‘runs’. An investor would feel confident that he would be paid in full in the event of a ‘failure’ by his society: he would therefore have no need to panic whenever there was uncertainty about the solvency of his society. (NAA A12933 195)

The submission raised a number of potential problems with the preliminary proposal. Apart from the potential cost and possible negotiation difficulties with the states, Commonwealth-sponsored deposit insurance would give a competitive advantage to building societies above those in other NBFIs and banks. Furthermore, such a scheme might necessitate the extension of financial controls to building societies. The RBA particularly saw the possibility of establishing a “quid pro quo” in which government participation in a deposits insurance scheme would be traded for greater control over liquidity and management (RBA Archives BM-Pe-202). On either 7 or 8 November 1977 the ad hoc committee resolved that Fraser should announce, at a timing of his own choosing, that the government was examining the possibility of a deposits insurance scheme.

In these crucial months, progress towards a capital market inquiry would be in tandem with the development of building society deposits insurance. The thinking on the latter informed and constrained the thinking on the former. At a Securities Institute lunch on 18 November 1977, Fraser recommitted the government to the capital markets inquiry he had first promised in 1975. While the inquiry was not a major election issue, as Prasser (2003) correctly notes, there was a close connection between this pledge and the building society crisis which had dominated the government’s economic policy focus at the end of 1977. Fraser reiterated his promise on 27 November (NAA A12933 542). In fact, both sides of politics went to the 1977 election promising an inquiry into capital markets. For the Labor Party, the purpose of such an inquiry was to encourage growth of capital markets “so that Australian companies
can mobilise the capital required to take part in new resources ventures” (Whitlam 1977). Gough Whitlam saw the question of business finance as a subset of the question of foreign ownership.

6.2.1 The loan council

The case for a broader inquiry was enhanced by other concerns the government had at the time. After their victory in 1977, the Fraser government started to work into the capital inquiry process a wide range of outstanding financial problems. For example, one major factor in the early development of the Campbell inquiry, emphasised both by Fraser (Fraser and Simons 2010) and Howard (Harper 1985) were the strictures placed on government borrowing through the Loan Council. The Loan Council set maximum interest rates for government securities at a margin just above the yields on Commonwealth bonds. It also regulated brokerage charges and underwriting fees. In times of low inflation such controls were of minor importance. But in times of high inflation, such as was being experienced during the Whitlam and Fraser governments, the reluctance of the Loan Council to raise interest rates left the sale of government securities badly undersubscribed. This also meant that the government had to rely on loans from the RBA, which had the perverse effect of further boosting inflation (Macfarlane 2006). In the view of John Rose, who was Fraser’s economic advisor at the time, the move towards market pricing “was the major step towards freeing up interest rates in Australia, because it took the Government itself into a market-oriented interest rate system” (Ayres 1987, p. 409). Fraser and Simons (2010) write that if “the interest rates on government securities were set by the market, deregulation of other interest rates followed naturally.”

In response to these concerns, the Treasury and the RBA in January 1978 proposed a tender system for the sale of Treasury notes, drawing on the experience of the United Kingdom and the United States (NAA A12933 221; NAA A13075 4703/MP). One obvious benefit of such a system was that the supply of
Treasury notes would be responsive to demand. Another further benefit was that yields, once set by the market, would be seen as “free from political constraints”. However, the Treasury and RBA warned of the possibility of wild swings in interest rates and a reduction of government influence over interest rates in the broader market. Ultimately, the two agencies concluded, the trade-off faced by policy makers was whether they would prefer the unpredictability of loan subscriptions, or the unpredictability of loan interest rates. This caused an interdepartmental furore within the Fraser government. The Department of Prime Minister and Cabinet supported reform, while Treasury and the RBA for the most part opposed any change (Fraser and Simons 2010).

The importance of the Loan Council issue in sparking the Campbell committee should not be overstated. A Treasury submission in mid-February stated that while the inquiry would tackle some aspects of Loan Council operation and finance operations by statutory authorities, it would not “cover detailed aspects of public finance”. Nor did the Campbell committee have any significant influence on policy change in this area. Treasury note tenders were launched in December 1979 – that is, nine months before the government received the interim report of the Campbell committee (NAA A12933 236).

6.2.2 From a capital markets inquiry to the Campbell committee

The conjunction of Loan Council issues, the election promise for a capital markets inquiry, and building society concerns led Rose and an economist from the Department of Prime Minister and Cabinet, Eddie Visbord, to recommend to Fraser on a flight between Melbourne and Canberra that the government instigate a wide-ranging inquiry into the financial sector encompassing all these issues (Ayres 1987; Weller 1989). The monetary policy committee (MPC) of the Federal Cabinet first directly considered Fraser’s election recommitment to a capital market inquiry on 9 February 1978 (NAA M2218 3), and
instructed the new Treasurer John Howard to bring forward the form of inquiry and a proposed terms of reference, which he did on 16 February (NAA A12933 236).

In July Howard took to the MPC two approaches the inquiry might take (NAA A12933 542). The first model addressed the government’s previous commitments in a minimal way. It would be a “fairly narrow inquiry confined to the efficiency of the capital market per se”, would only examine financial institutions that were directly involved in capital markets, and would “ignore most of the operations of the banking system, money markets and the Reserve Bank.” Such a model would not have addressed the politically salient questions of stability in the NBFI sector. The second model was to be a “broader inquiry into the functioning of the financial system”, and was to include an examination of the Reserve Bank, NBFIs, money markets, and the banking system. The MPC resolved to pursue the broad model.

The terms of reference for the Campbell committee were finalised in late July 1978 (NAA M2218 7). These placed the government’s ideological predilections right up front. “In view of the importance of the efficiency of the financial system for the Government’s free enterprise objectives and broad goals for national economic prosperity”, the committee was asked to inquire into the “structure and methods of operation” and regulation of the financial system including banks and NBFIs, the securities industry, the money market, development finance institutions, and the RBA. The committee was to make recommendations for the “improvement” of the system and its regulation, and any other recommendations it deemed relevant. This gave the committee a “virtual blank cheque” to inquire as it saw fit (Wilson 1979).

The membership of the committee indicated the direction the government wished the inquiry to take and was a source of some small controversy. The final five person committee was skewed in favour of the private sector. “All were sympathetic to freer markets” (Henderson 1992, p. 224). The chairman,
James Keith Campbell, was chairman of the real estate firm the Hooker Corporation. Hooker had been involved in an attempted rescue of Home Units Australia during the building societies crisis of the early 1970s. Also from the private sector were Keith Halkerston, a financial advisor, and Alan Coates, General Manager of the AMP Society. The MPC also considered the Australian-born James Wolfensohn, then a partner of Salomon Brothers, and later to be president of the World Bank. Charles Goode, a partner at Potter Partners and later chairman of ANZ Bank, was an early appointee to the committee but had to withdraw (NAA M2218 10). Howard (2010, p. 112) says he “ignored the urgings of some to appoint a token regulator” but public sector interests were represented by Dick McCrossin, General Manager of the Australian Resources Development Bank, and Jim Mallyon, of the RBA, which was responsible for regulating the banking sector. On 18 January 1979, Howard announced the inquiry and the membership of the committee, explicitly stating that:

the objective of the inquiry was not more regulation by the Government. Indeed, one of the important issues to be canvassed by the Inquiry would be whether present levels of regulation and Government involvement were appropriate (Howard 1979, p. 2).

The Labor opposition complained the committee’s make-up was “extremely inadequate ... a narrow based committee which is much more likely to produce a report that is in the interests of financial institutions rather than in the interest of all Australians” (Bright 1979).

6.2.3 The building society deposit scheme

The Campbell committee released its final report in November 1981 - four years after Fraser had reiterated his capital markets inquiry promise and four years after the collapse of QPBS. Such a long lead time meant that the pressing political matters of 1977 could not be fully shunted off to the Campbell committee. Urgent financial regulatory reform had to be enacted throughout the period of the
committee’s inquiry. Even after the committee’s report had been tabled, unravelling its policy proposals into a politically viable and desirable legislative agenda was a substantial task. By the 1983 election, interdepartmental committees were still working through the Campbell recommendations. This delay was not helped by a belief within the committee, transmitted to Fraser, that financial reform was an all-or-nothing proposition (Fraser and Simons 2010).

While the building society crisis was the spark for the broader capital inquiry, Fraser had promised during the 1977 election to implement a deposit insurance scheme for building societies (Fraser 1977). This was a public political promise. As the Campbell committee was being debated and formed, a parallel investigation into the operation of a deposit insurance scheme was underway. Under the Whitlam government, the RBA had considered and rejected the proposal of the AAPBS on moral hazard and boundary problem grounds. Deposit insurance, in the RBA’s view, “could encourage unsatisfactory and immature management practices”. Furthermore, it was not clear why building societies should receive special government protection but not other banks or NBFIs. The RBA recommended that the AAPBS consider establishing its own mutual insurance scheme without government support (RBA Archives RD-NS-179).

In early 1978 a working party of officials from Treasury, Prime Minister and Cabinet, and the Reserve Bank was formed to revisit the matter and investigate “such matters as the causes of the instability experienced by building societies and other deposit-taking non-bank institutions and the various mechanisms available to contain or mitigate the effects of such instability, including deposits insurance in particular” (NAA A12909 2655). Commonwealth officials met with state officials to discuss the issue in April 1978, and a report of the working group was delivered by the Treasurer to Cabinet in October 1978.
The working party argued that to target instability in the sector, any scheme would have to be matched
with increased prudential regulation to tamp down excess building society risk-taking. Yet should such
measures be undertaken, whether by state governments or the Commonwealth, the need for deposit
insurance would be greatly reduced. The report emphasised the interaction between this possible
deposit insurance scheme and other parts of the financial system. A government-backed protection of
building society deposits could significantly shift the competitiveness of building societies and effect
banks and NBFIs alike. As a consequence, it suggested that one possibility would be to delay
consideration of deposits insurance until the Campbell committee reported (NAA A12909 2875).

Howard considered this had “considerable merit”, particularly given

The wide-ranging implications that any effective deposits insurance scheme for building societies
could be expected to have for other sectors of the capital market, especially the potential for short
term disruption to financial markets, and the strong opposition of most major groups of financial
institutions, apart from building societies (NAA A12909 2875).

However, Howard was unable to endorse this suggestion in the light of the promises made in the 1977
election campaign and the political risk of a new building society crisis:

Awaiting the outcome of the Inquiry into the Financial System would delay effective action on
deposits insurance for some years, although the Inquiry could be asked to consider giving some
priority to this matter. It would also attract criticism from a large segment of the building society
movement, and there could perhaps be some wider criticism if there were another “run” on building
societies (NAA A12909 2875).

In Howard’s view, by encouraging state governments to increase their regulatory control and
supervision of building societies, the Commonwealth could protect itself from accusations that it was
failing to act, while still allowing the Campbell committee time to consider the proposal. The Cabinet
resolved to work with the states, and asked the working party to pursue and develop further detailed models for a deposit insurance scheme, including one wholly owned by the RBA, and another held by a separate statutory authority (NAA A12909 2875).

The result of this process was a compromise position. The working party spent the next year negotiating with building societies, other finance firms, and state governments to develop a scheme. This included consultation with the Campbell committee, which urged the government to hold off on a final decision. Howard returned to Cabinet in February 1980 with a proposal to facilitate a private, voluntary industry-based deposits insurance scheme (NAA A12909 3781). Capital would be provided by the permanent building societies, and ownership would be wholly independent of government. The Commonwealth government would have a purely coordinating role; that is, it would facilitate discussions between building societies, states, and Commonwealth agencies such as the RBA. It would publicly endorse the scheme to ensure it had credibility. This was a significant change from the 1975 position, when the RBA had wanted the government to stay as far away from any voluntary scheme as possible to avoid implying the scheme was backed by the government (RBA Archives RD-NS-179). Finally, Howard committed the government to making any minor legislative changes required to ensure the smooth operation of the scheme.

6.2.4 The Campbell committee as a kitchen sink

The building society deposit insurance scheme was not the only loose end that needed to be tied before the finalisation of the Campbell committee’s report. By considering how proposals for financial regulatory change were discussed between the decisions to establish the Campbell committee and the release of its report, we can see how the expansive breadth of the Campbell committee possibly delayed
piecemeal market oriented reform – including, suggestively, the introduction of foreign banks into Australia.

In response to the outstanding request from the MPC for an investigation into the proclamation of the Financial Corporations Act, in October 1978 and January 1979 Howard presented two papers prepared jointly by the Treasury and RBA to the MPC (NAA A12933 733; NAA M2218 11). The first submission made the strongest case against the proclamation of Part IV yet. The paper made it clear that the government was driven by a political philosophy to reject interventionism and favour, whenever possible, market-based solutions: “proclamation of Part IV would disrupt markets and would be contrary to our philosophy on bureaucratic regulation” (NAA A12933 733). The second submission was even more forthright in its desire for market reform. Surveying the banking sector in general, it argued that the government’s priority ought to be to level the playing field between the regulatory framework faced by the banks and that faced by the NBFI sector and “endorse the view that this general objective can best be advanced by moves towards ‘deregulation’ of banks, by reliance on broad ‘market oriented’ monetary measures, and by the application of suasion techniques to bank and non-bank intermediaries where appropriate” (NAA M2218 11).

In a memo appended to Howard’s January 1979 MPC submission, the Department of Prime Minister and Cabinet noted that the paper had not considered “the question of deregulation of the barriers to entry of new foreign owned banks”, despite the fact that in October 1978 the MPC discussion had specifically asked for such considerations to be included (NAA M2218 11). The significance of this is that it shows that four months before the Campbell committee was formally announced, the Fraser government was already discussing internally the possible introduction of foreign banks into Australia. Nevertheless,
proper consideration of opening the banking market was delayed until after the Campbell committee’s
report.

Indeed, the Campbell committee acted as a sink into which the Fraser government was able to pour
regulatory proposals in such varied areas as housing and manufacturing. In the economic climate of the
1970s, the Campbell committee became the Fraser government’s central deliberative body for reform. It
was also the most consistently market-orientated. In March 1979 the Report of the Study Group on
Structural Adjustment, headed by Sir John Crawford, was released, which recommended tariff
reductions to stimulate industrial adjustment as well with export subsidies to ease the transition. The
Crawford report was criticised for excessive interventionism (see Kingma and Volker 1980). As a Cabinet
paper from Department of Prime Minister and Cabinet wryly commented on the private interest
substance of the Crawford report:

The report recommends a long list of measures and it is likely that it will be favourably received by
many sectional interests who will strongly press for adoption of the particular recommendations of
benefit to them (NAA A12930 35).

Cabinet considered immediately distancing itself from the report (NAA A12930 35). Instead, at the
recommendation of Fraser, the Cabinet decided to roll its proposals into the Campbell committee.
Howard subsequently requested that the Campbell committee consider the availability of export
finance, and the provision of equity and long-term finance to small and medium size firms (NAA A12930
94).

A further request was made in August 1979 for the Campbell Committee to consider the establishment
of a secondary mortgage market. This was drawn from the Fraser government’s independent Inquiry
into Housing Costs, which had been formed in 1977 and reported to the government in September
1978. The three-person committee on housing costs included Keith Campbell. The inquiry was launched in response to a rapid land price inflation in the mid-1970s, and the Fraser government was concerned to stabilise the price of land (NAA A12909 752). An editorial in the *Age* (21 September 1978, p. 11) argued that governments had been reluctant to “step in and control the activities of land speculators”, which had resulted in the sharp price increase. The terms of reference directed the housing inquiry to focus on specific government policies which might have pushed up the price of housing, such as planning approvals, regulatory costs, and infrastructure provision.

Like the Crawford report, the Inquiry into Housing Costs had a strongly interventionist streak. While it recommended some regulatory reduction, standardisation and consolidation, it also proposed Commonwealth and state government subsidies for research and development into innovative housing forms, and the introduction of incentives for rental accommodation construction. The inquiry considered that price instability was a result of volatile change in supply and demand, and therefore recommended the establishment of a new Commonwealth secondary mortgage agency “as a means of stabilising funds flows over time and between regions within the constraints imposed by broad monetary policy” (NAA A12909 2575). Cabinet considered the inquiry’s report, along with the report of an interdepartmental committee formed to examine the inquiry’s recommendations, in August 1979 (NAA A12909 3412). The interdepartmental committee suggested that a secondary mortgage agency was hasty and recommended further investigation. Objections to many of the inquiry’s recommendations came from the Treasury and Department of Prime Minister and Cabinet on the grounds that they were either the responsibility of private industry or state governments rather than the domain of the Commonwealth. The Cabinet resolved to refer the issue to the Campbell committee.
These decisions are more than vignettes into bureaucratic and administrative decision-making. In these intra-governmental choices, we can see how the Campbell committee process became the fulcrum on which the ideological presumptions of the Fraser government tilted from the regulatory interventionism suggested by these inquiries to the deregulatory approach that was to characterise the Campbell committee recommendations. However, that deregulatory approach had one significant exception: its approach to prudential regulation.

6.3 The Campbell committee report goes to government

Given the Fraser government’s use of the Campbell committee to redirect considerations of policy matters from industry assistance to housing affordability, it perhaps ought not have been a surprise that the final report presented a reform agenda that was both comprehensive and politically unwieldy. The Campbell committee’s interim report was brought to the MPC in August 1980. The interim report presented an overview of the state of the Australian financial system, and the regulatory framework governing the sector. It refrained from offering any policy advice. On its public release later that month, McCrann (1980) wrote that the decision to hold off on its assessment of various proposals was “puzzling, even disappointing,” and appeared to be concerned with “not feeding ammunition to critics or special interest groups.” Nevertheless, one notable finding of the interim report was that the shift from banks to NBFIs had slowed during the 1970s, in part due to the financial crises which had effected building societies and finance companies. The Campbell committee saw its primary aim as improving the financial system’s allocational and operational efficiency, but noted that efficiency could come into conflict with other policy goals – the operation of monetary policy, stability and competition concerns, and social equity considerations. While Howard believed the Campbell committee had overextended itself to a degree by considering matters outside its already broad terms of reference (such as monetary policy and company tax), the report was broadly in line with the government’s policy intentions (NAA
Yet when the final report of the Campbell committee (“the Campbell report”) was delivered to Howard at the end of September 1981, the size of the report – as well as its far reaching implications – caught the government off-guard (Prasser 2003). Cabinet only agreed to table the report in parliament and to consider the recommendations of the committee at a future date (NAA A13075 17086).

The Campbell report was structured around two principles. The first was a philosophy of market competition in the financial sector. While an unregulated free market may suffer from the disorder costs of asymmetrical information, or instability problems, it was nevertheless the case that “the most efficient way to organise economic activity is through a competitive market system which is subject to a minimum of regulation and government intervention” (Committee of Inquiry into the Australian Financial System 1981, p. 1). These sentiments closely hemmed to the terms of reference which instructed the committee to be cognizant of the government’s free enterprise objectives. The second principle was that of competitive neutrality. This was the “conceptual pivot” of the report (Congdon 1982). Financial services that are alike should face regulatory constraints that are alike. Competitive neutrality would maximise the allocative and operation efficiency of the financial sector. To achieve competitive neutrality, the committee recommended a reorientation of regulation along ‘functional’ lines, whereby regulation was applied to financial services according to the function they fulfilled, rather than on an institutional basis – for example, building societies which offered deposits should be regulated on the same grounds and with the same intensity as banks that offered deposits. The Campbell committee noted that

> It is, of course, true that it is not always easy to draw precise lines around different ‘activities’ or segments of the market. Ultimately, every borrowing or lending activity is in competition with every
other and this will be especially true in the more integrated financial system envisaged by the Committee. (Committee of Inquiry into the Australian Financial System 1981, p. 5)

The recommendations of the final report of the Campbell committee are often depicted as uniformly deregulatory. Kelly (1992, p. 78), for example, writes that the report was “comprehensive and coherent in its recommendations of financial deregulation and its view that market-related mechanisms would maintain economic stability.” The Campbell committee considered lending and interest controls as a primarily a mechanism of monetary policy, and recommended the abolition of interest rate controls, maturity controls, and absolute and relative lending controls. It dismissed the possible social and prudential benefits of lending controls as “not substantial – if they exist at all” (Committee of Inquiry into the Australian Financial System 1981, p. 68).

However, the Campbell report was far from uniformly deregulatory. In several crucial areas it pulled its punches, recommending less deregulation than ultimately occurred, favouring regulatory consolidation over deregulation, and seeking to accommodate the self-interested concerns of the private sector. One of the most striking illustrations of compromise in hindsight is the Campbell committee’s argument that while the prohibition on foreign banks ought to be removed, the rate of bank entry be “carefully managed” as foreign entry and investment could lead to “a socially unacceptable loss of resident ownership and control” (p. 440). Indeed, while the committee favoured markets as a presumption and according to its political mandate, it was not uniformly supportive of market policy. Situating the report in the ideological debates of the time, McCrann (1981) wrote that

It would be unfortunate if the Campbell report came to be regarded as the complete and true repository of the free enterprise ethic and the supremacy of the market mechanism in the creation of human welfare. This is not so ... Indeed Treasurer John Howard can comfortably reject all or part of the report without renouncing either his or the Government’s commitment to “free enterprise”.
6.3.1 Prudential policy and the Campbell report

The clearest example of the Campbell committee’s deregulatory reluctance was in its approach to prudential regulation. The report recommended that banks be subject to a range of controls in order to protect depositors and investors and ensure the stability of the banking system. Banks were to be subject to transparent capital adequacy requirements, and possibly a two-tiered capital adequacy ratio. Banks would have to adhere to regulated liquidity ratios for prudential (not monetary) purposes. Loans to controlling shareholders and directors should be subject to limits, and consideration be given to regulating certain classes of speculative or developmental property and foreign exchange dealing with special risk asset limits. New foreign and domestic banks would be subject to the same regulatory burden (pp. 296-317).

The report argued that while the prudential regulation imposed on NBFIs accepting deposits should be “generally comparable” with that imposed on banks, it “should be less rigorous”. As Congdon (1982) and Valentine (1983) noted, this was a clear violation of the committee’s principle of competitive neutrality.

The Campbell committee believed banks were special for three reasons:

- Trust is a pre-condition for an efficient payments system: cheque-clearing institutions must be able to deal confidently with one another,

- It is widely accepted that there is a need for a small safety haven for small investors, a role that has traditionally be filled by the banks; and

- A banking collapse which involved depositors in significant losses could be expected to create substantial disturbance in financial markets and therefore in the economy as a whole. (p. 296)
Unfortunately these criteria were not elaborated. It may have been the case that banks dominated the payments system but that was not guaranteed to be the case into the future. A fully automated paperless payments clearing system was introduced to Australia in 1977 (Horne 1985). In 1979, the first Australian non-bank financial institution installed an automatic teller machine (Hohne 1985). Credit cards, electronic funds transfer systems, and fully automated clearing houses all suggested that financial innovation could reduce the privileged position of banks in the payments system.

The Campbell committee’s approach to prudential regulation produced “a strong bias towards over-regulation” (Hogan and Sharpe 1983, p. 146). The Campbell committee sought to match regulatory objectives with individual regulations. This meant that each possible risk faced by depositors needed its own, distinct regulation to govern it. The three different prudential risks in the mind of the committee were solvency risk, liquidity risk and risk associated with market imperfections. Therefore the committee recommended three regulatory solutions: capital adequacy controls, liquidity controls and disclosure requirements. But regulatory interventions can be ‘dual-purpose’ – a single intervention might mitigate multiple market failures. The Campbell committee recommended the retention of the LGS requirement to reduce ‘liquidity risk’. Yet as Hogan and Sharpe (1983, p. 158) asked, “what function is performed by a liquidity control which is not performed more efficiently by a capital requirement or a variable rate deposit insurance scheme? When the question is framed in this way, the conclusion is clearly that liquidity controls are superfluous”.

An international comparison is instructive. The Campbell committee did not adequately focus on the prudential role played by the American system of deposits insurance (Hogan and Sharpe 1983; Perkins 1982). While it conceived capital adequacy requirements as the central American mechanism for
depositor protection, it missed that those requirements were closely interdependent of the scheme of federal deposit insurance:

capital regulation in the United States does not have as its objective depositor protection. Deposit insurance serves that function. The purpose of capital regulation is to prevent banks from increasing risk levels, which is economically rational behaviour given the fixed rate deposit insurance premium. In other words, it is intended to protect the insurance fund, not depositors (Hogan and Sharpe 1983, p. 148).

The assessment that the prudential parts of the Campbell committee was weak was understood by the Fraser government. Howard considered the prudential regulation sections of the final report as “among the most unsatisfactory and difficult to understand parts of the Report” (NAA A12909 5656). This complaint was as much practical as conceptual. While the report offered some principles under which prudential regulation might be devised, too many of the key decisions about the appropriate regulatory mechanisms had been left for the government to resolve.

Indeed, the breadth and comprehensive nature of the Campbell report was itself a barrier to implementing its recommendations. That challenge was enhanced by the Campbell committee’s belief that it “sees danger in a piecemeal, fragmented approach to reform ... it may be counter-productive if the Government were to implement certain recommendations while indefinitely deferring others” (p. xxx). It is possible to see an echo of that warning in Fraser’s recollection that “The financial system is a tightly woven braid. Pull on one thread and all the others must move” (Fraser and Simons 2010, p. 529). For his part, Keith Campbell regretted that warning. Campbell told Paul Keating in April 1983 that to implement even some of the report would make an enormous difference to the health of the financial sector (Edwards 1996). Nevertheless, Cabinet resolved to push its recommendations onto an interdepartmental task force which would report back throughout 1982 and 1983.
One further explanation for referring the Campbell recommendations to an interdepartmental committee process was to forestall internal disagreements about the desirability of regulatory reform. Less than a month after the release of the report, the former Treasurer Phillip Lynch told an audience in Sydney that the government was unlikely to remove controls on interest rates. Howard was telling an audience in Melbourne that very day that the government was keeping its options open (Davis 1981). Cabinet consideration of Campbell report recommendations lasted throughout 1982 and early 1983. Many of the recommendations received in principle Cabinet support. Nevertheless, the Cabinet was still considering some of the most critical recommendations when the 1983 election was called on 3 February that year.

6.4 Labor and the Martin Group Report
The decision to act on the Campbell Committee’s recommendations under the Hawke government has been subject to almost as much personal dispute as the decision to instigate the committee in the first place. Howard had provided the Campbell report to the Labor opposition thirty-six hours before it was tabled in parliament. Ralph Willis, then shadow Treasurer, said that the report’s recommendations would have a “devastating impact on our society”, and were driven solely by the Fraser government’s free enterprise ideology (CPD, House of Representatives, 17 November 1981, p. 2856). Internally however, Labor was divided. Shortly before the final report was released, Paul Keating said he supported increasing competition in banking, on the grounds that it would wake up “the drones of the Australian banking industry” (The Age, 13 October 1981, p. 31). Keating, along with Bob Hawke, had argued in caucus that Labor ought to support the thrust of the Campbell report but were defeated by Willis (Edwards 1996; Hawke 1994).

Nevertheless, Hawke took the same policy to the 1983 election that had been devised by Gough Whitlam in opposition: Labor would proclaim Part IV of the Financial Corporations Act and “maintain
interest rate controls on bank mortgage interest rates and extend those controls to building societies”. A promise to proclaim Part IV was also included as part of the Accord between Labor and the Australian Council of Trade Unions (McCarthy and Taylor 1995). The Hawke government intended that Commonwealth control would be used to channel financial funds to housing, through an Australian Housing Fund and a requirement imposed on savings banks and building societies to lend a minimum percentage of funds for housing (Hawke 1983). And despite his earlier public statements, Keating took a traditional Labor line on foreign banks and interest rates during the 1983 campaign, arguing that “foreign bank entry will force up interest rates for individual borrowers, small businesses, farmers &c”, as well as exposing Australia to international instability and weaken domestic monetary control (Keating 1983).

Yet almost immediately after the 1983 election Keating began telegraphing the government’s eventual reversal of its pro-regulation position. In one of his first interviews after becoming Treasurer, Keating suggested that Labor was accommodating itself to deregulation, although he maintained the election promise that Part IV would be proclaimed (Mockridge and Short 1983). A fortnight later Keating was asked about Part IV again and declined to directly answer whether he would proclaim the provision, instead saying while he did not agree with all the Campbell committee’s recommendations, “I think it would be a mistake to let the Campbell report simply collect dust on the shelf” (Gittins 1983).

In late April 1983 Hawke and Keating agreed to commission a report to review the recommendations of the Campbell committee. The Martin Group was headed by Vic Martin, of the Mutual Life and Citizens’ Assurance Company. The choice of Martin helped placate the left of the Labor Party that Keating was not heading down the ideological free enterprise path of the Fraser government (Pauly 1987). In a paper in 1981, Martin had written that he had “not seen a case of any substance put forward which would
convince me that [foreign bank] entry was warranted” (Martin 1981). The Martin Group’s mandate was not to replicate the work of the much larger Campbell inquiry, but to assess its recommendations according to:

[the Government’s social and economic objectives, particularly the need for an adequate supply of finance at a reasonable cost for the housing, rural and small business sectors, and their implications for the financial system (Australian Financial System Review Group 1984).]

This was, as Gittins (1984b) put it, “a nice way of saying: having regard to what Paul Keating could reasonably hope to get [Labor] caucus to swallow.”

The Martin Group provided its report to Paul Keating on 21 December 1983 – two weeks after the government had floated the Australian dollar. The government sat on the report until late February 1984, although details of its findings dribbled out during the intervening months. The Martin Group report had a different ideological frame to the Campbell Committee yet reached much the same conclusions. Where the latter had proclaimed that free enterprise was the most efficient mechanism for allocating resources, the former was quick to disclaim such bold principles: the Martin Group report professed to be “pragmatic”, and declared that it “does not rely upon general presumptions, derived from theoretical models, about the operation of unregulated markets” (Australian Financial System Review Group 1984, p. 94). But as Valentine (1984) pointed out, this denial of a theoretical basis for its analysis only meant that it was hard to determine exactly what approach the Martin Group took. The Campbell Committee proclaimed that it was for free enterprise and recommended deregulation tempered by concessions to social policy and increased prudential regulation. The Martin Group proclaimed that it had no general philosophy and ultimately recommended deregulation tempered by concessions to social policy and increased prudential regulation. The major difference between the two
approaches was aesthetic. Both recommended the deregulation of interest rate controls, and both were against the extension of those controls to NBFIs. Both recommended the introduction of foreign banks. Both suggested that major problems in sectoral finance were created by excessive regulation.

The Martin Group supported the Campbell committee’s proposal to maintain the distinction between banks and NBFIs, once again using the role of banks in the payment system and the desirability of a safe haven for depositors’ funds as justification. It recommended the entry of foreign banks through an incongruously named ‘tender’ system that was really just a limited application process (Valentine 1984). It recommended that the maximum share of foreign ownership in a new foreign bank should be fifty percent. The number of new banks should be restricted to between four and six, and, in the Martin Group’s opinion, should be seen as a once-off concession to entry. This limitation was justified in part on prudential grounds. In its view, too many new banks would be destabilising and risk future bank failures.

6.4.1 Prudential regulation and the Martin Group Report

On prudential regulation, the Martin Group varied little from the Campbell committee’s recommendations. There was one significant difference however: the Martin Group believed that, all else being equal, new banks should be subject to greater prudential regulation than established banks:

The inevitable lack of an established financial record, at least domestically, would suggest that new banks initially observe capital ratios than those of existing banks. The likelihood of heavy reliance on ‘bought’ funds while a more stable deposit base was being established would be another reason for the initial observance of a higher liquidity standard (Australian Financial System Review Group 1984, p. 141).
As McCrann (1984) notes it is hard to imagine the incumbent Australian banks were displeased with such arguments, as they would benefit from rents accrued by the higher regulatory burdens placed on their new competitors.

Both the Martin Group and the Campbell committee’s approaches to prudential supervision were a variation on existing practice. Under the proposed regulatory frameworks, prudential regulation would be a matter of discretion and consultation between individual banks and the RBA. While both offered greater specificity about the mechanisms through which supervision was to be practiced, and were to be based on regulatory requirements rather than cooperation, in fact these differences were more aesthetic than material. In practice, both the proposals of the Campbell committee and the Martin Group gave the RBA substantial discretion to vary the regulatory burden, if not the regulatory mechanism, according to the RBA’s assessment of the risk profile of individual institutions.

Both the Campbell committee and the Martin Group rejected the possibility of a bank deposit guarantee or a deposit insurance scheme. Neither inquiry looked at any depth at s 14 of the Banking Act 1959 whereby the RBA took over the operations of a bank unable to meet its obligations to depositors. The Campbell committee considered s 14 as a form of solvency support arrangement. As it noted, the obligation to protect depositors created “a strong perception that the private banks have a large measure of government support” (Committee of Inquiry into the Australian Financial System 1981, p. 310). In this, the Campbell committee considered two alternatives to the status quo. First, there was the possibility of abolishing the Banking Act’s depositor protection provisions and requiring the banks to establish an industry-based deposits scheme as was being pursued by the building society sector. This, however, the committee considered to be a risk to the competitiveness of the sector, as such a scheme could be used as a cartel-like barrier to entry. The second alternative was the provision of a formal
government guarantee to all depositors which it rejected on the grounds of competitive neutrality. The committee concluded that the preferable option was to leave s 14 as it was, and recommended the RBA publicly explain the extent of its obligations to depositors. The Martin Group, a much less comprehensive document, did not scrutinise s 14 of the Banking Act at all.

6.5 Conclusion
The Campbell committee set the frame of reference through which financial sector reform was to be considered. For the most part the Martin Group followed the Campbell committee’s lead. It is striking how similar the two inquiry’s recommendations are given their purportedly different philosophical frames. That both the Fraser government and the Hawke government - the latter implacable critics of the former for its economic radicalism - could produce something so similar suggests deeper forces were at play than mere partisan ideology.

This confluence of policy goals might accord with the public interest interpretation of regulatory change. This interpretation focuses on the growth of the NBFI sector as a policy problem which needed to be solved, and the identification of financial repression as a handbrake on growth. However, such a public interest interpretation has weaknesses. All these issues were present in 1974 when the Whitlam government sought to bring NBFI s into the financial repression that had governed Australia banking. The Labor Party executed a complete about-face between 1974 and 1984 in its approach to financial regulation, yet the policy problem both Labor governments faced was substantially the same. It is hard to argue that the Whitlam government were ideological while the Hawke government publicly interested (or vice-versa) without offering an explanation for that difference. It is not at all clear why legislators would be ideological in one decade and publicly interested in the next.
The public choice literature has struggled to explain the decisions which led to financial deregulation (see for instance Kroszner 1999; Peltzman 1989). While financial repression seems readily explainable through reference to privately interested firms and governments, the rapid dismantling of that repression is less explicable, as a market-based order would seem to offer fewer rents that could be captured by the political system. In the Australian case it is nonetheless easy to identify private interests who benefited from deregulatory policies relative to the status quo. The trading banks who lost their market share to NBFIs gained an advantage when the constraints placed on their business were lifted. It is indicative that within the banking sector there was an argument as to whether deregulation of banking or regulation of NBFIs should be preferred. Likewise, trading banks might be unhappy with the introduction of competition from foreign banks that might dissipate their rents but the Martin Group in particular offered concessions to the incumbents: a limited introduction of foreign banks was exchanged for almost complete deregulation of interest rate controls and the benefit of RBA depositor protection. One alternative explanation might be that the drive towards financial reform delivered rents to the state. Noll (1989) dismisses out of hand such Leviathan explanations for deregulation in the United States. Yet in Australia, restrictions on Loan Council borrowing were a constraint on the revenue raising powers of the state. In the prudential sphere, the firm support given by both the Campbell committee and Martin Group for discretionary policy vested in the RBA accords well with bureaucratic interest models (Niskanen 1971, 2008). The RBA’s preeminent role in the management of financial institutions was greatly expanded by notions of competitive neutrality - which brought more of the financial sector, and a greater share of the nation’s economic activity, under its supervision. Furthermore, its flexibility to manage the liquidation of financial institutions was not impeded.
Olson (1965, 1982) and Glaeser and Shleifer (2002) emphasise how previous decisions shape future decisions. Institutional change is path-dependent. This is most clear when we view the relationship between the unproclaimed Part IV of the Financial Corporations Act and the Campbell committee. That provision shaped the political decisions that ultimately led to deregulation. The Australian government was forced into considering a short-term regulatory response - a building society deposit insurance scheme - that sat uncomfortably with its parallel considerations of the financial sector as a whole. The relationship between the two processes affected the shape of the financial Campbell committee’s recommendations.

Ideological explanations for the Campbell committee have been at the forefront ever since it was established. The Fraser government placed its ‘free enterprise objectives’ up front in the terms of reference, and was part of the Labor critique of the committee, both explicitly while they were in opposition and implicitly through the reframing of the ‘pragmatic’ Martin Group. Yet in practice, both the Fraser and Hawke governments followed the same reform ideas. An ideological shift characterises both popular and scholarly accounts of the Campbell committee and the deregulation it brought about. For example, Whitwell (1986, p. 248) places the “philosophical preconceptions” of the Campbell committee first and foremost, but depicts the committee as a leading indicator of the shift from Keynesianism to neoclassicalism within the economic policymaking community. This chapter and the previous chapter has sought to identify with a high degree of precision the moment of that shift from economic interventionism to market reform, and identify the historical context in which it was made – a now-largely forgotten economic crisis in the building society industry and demands to proclaim an unproclaimed part of Whitlam government legislation.
Yet we need to consider the significance of the Campbell committee’s recommendations for more prudential supervision and regulation – proposals which contradict the received wisdom that the inquiry was uniformly deregulatory. The institutional change which resulted from the inquiry was not clear cut. On prudential policy at least, what the Campbell committee proposed was a movement along the IPF towards more social control rather than less. This movement is readily understandable through the political context described in Chapter 5. The perceived costs of market discipline in prudential policy for building societies increased in the 1970s. In that environment it was unlikely that there would be any political appetite for a reduction of prudential control on the financial sector.

This rise in perceived disorder costs from market discipline in the late 1970s cast a long historical shadow. As the next chapter will show, ideas about the management and conduct of prudential policy had to be resolved in the 1980s as regulators were faced with not four or five but more than a dozen new entrants with which they lacked the relationships to pursue the previous model of supervision. New banking competition brought with it its own challenges for the stability of the financial system. Prudential regulation was the foundation on which later regulatory growth in the financial sector was based. It is to the prudential significance of foreign banks and a more competitive banking sector that we now turn.
7 FOREIGN BANK ENTRY AND THE FORMALISATION OF PRUDENTIAL REGULATION

7.1 Introduction
Restrictions on entry are one of the oldest forms of banking regulation (Grossman 2010). Australia’s first bank owes its origins to the evasion of charter restrictions that favoured the Bank of England. The establishment of the Bank of New South Wales in 1817 by Governor Macquarie was intended to accompany the prohibition on “petty” banking by private note issuers who had stepped in to fill the colony’s monetary demands. The Bank of New South Wales was granted a charter with limited liability - a decision which was made by Macquarie without the authority of the British government, and possible only thanks to no small amount of diplomatic sophistry on Macquarie’s behalf (Butlin 1953, pp. 113-7). The result was that the Bank of New South Wales was one of the world’s first private commercial banks (Grossman 2010).

This chapter traces the relationship between entry restrictions, ownership controls and prudential regulation in Australian banking from before the Second World War until the late 1990s. The 1945 Banking Act restricted the use of the word ‘bank’ to firms which were either named in the legislation or could acquire a banking license from the Treasurer. Throughout the late 1960s and 1970s strict controls on entry dovetailed with those decades’ popular and elite concerns about foreign investment in Australia. After the Campbell and Martin Group reports, Australian policymakers reversed their approach to foreign bank entry, culminating in Paul Keating’s decision to approve 16 new bank licences in February 1985. Nevertheless, this did not represent a full reversion to market discipline in ownership. Restrictions on who could invest in banking remained. Rather, the public and private justifications for social control of bank ownership shifted, as it had in earlier periods, according to prevailing ideas about competition, prudential stability and economic nationalism.
The political story of the introduction of foreign banks has been told before. Martin (1999) comprehensively details the process by which the Hawke government was able to bring the Labor Party across to accepting the introduction of new banks but does not relate the decision to introduce foreign banks to wider institutional changes in banking regulation. Pauly (1987) is an early overview of the political economy behind foreign bank restrictions and entry in Australia. Knowles et al. (2010) is a valuable case study of the introduction of Citibank into Australia.

The analysis here differs from these in that it focuses on the institutional setting of foreign bank entry: not just the change in economic philosophy within the Labor Party but more importantly the way foreign bank entry necessitated a change in prudential regulatory practice. The constrained number of banks operating under Commonwealth law partly determined the institutional possibilities of prudential control. New licenses brought about a practical need for formalisation of prudential rules - as regulation could no longer be governed by pre-existing relationships - and a corresponding demand from the new banks for clarification about the rules they were expected to operate under. Favouring market discipline for entry increased the perceived disorder costs of prudential control.

The first part of this chapter begins with an account of the informal and statutory controls on foreign banking before the Campbell committee. It then details the introduction of the Bank (Shareholdings Act) 1971, a regulatory constraint that is typically left out of the narrative about the introduction of foreign banks in Australia. The chapter then looks closely at the internal political discussions surrounding the introduction of foreign banks by the Hawke government and the emphasis on prudential regulation that accompanied it. Finally the chapter explains how that introduction led to changes in the structure and governance of prudential controls. Bank entry led to the formalisation of regulation, the outsourcing of surveillance to banks’ external auditors, and changes to the LGS ratio and SRDs. This chapter has a
particular focus on how the justifications for regulatory instruments changes over time. In this period, much of what was seen as tools for monetary policy became reconceptualised as prudential tools. Through this window we can see path dependencies in regulatory form and function, and underscore the importance of ideas as a dynamic element in regulatory construction. In each case, the analysis is informed by a close examination of Cabinet and Treasury archives that have not yet been used in the scholarly literature.

7.2 Foreign banking under financial repression
Foreign banks, particularly British banks, were a central feature of the Australian finance sector from the 1830s onwards. They introduced to the tiny Australian market banking skills that the colony lacked, imported banking practices from Europe (such as Scottish-style branch banking), and provided the industry with access to capital that their native competitors were unable to provision. British banks had a further advantage in that their London presence gave them an outsized role financing trade with the colony. It was only by Federation that Australian banks were able to compete on these grounds with the British banks.

Until the introduction of the Banking Act in 1945, banks did not require a license from the Commonwealth government to operate. The existing trading banks spent the first half of the twentieth century aggressively lobbying the federal government to limit entry into Australian banking (Knowles, Patmore & Shields 2010; Schedvin 1992). Legislation drafted in 1919 to regulate the banking sector would have required all banks conducting local business in Australia to have their headquarters in Australia. Further legislation drafted in 1929 would have required foreign banks to hold assets equivalent to deposits in Australia. Neither of these bills were introduced into parliament.
However, this did not mean that the social control of entry was *laissez faire* in the interwar period. Informal controls and suasion held back foreign entry competition (Merrett 1990, p. 70). The experience of the National City Bank of New York (NCB), later to be called Citibank, is instructive. It first attempted to enter Australia during the First World War. However, under wartime controls banking was “brought within a framework in which the conditions of business were the result of negotiations between governments and banks collectively” (Butlin 1961, p. 355). Upon receiving notice of a request for approval from NCB to enter the market in 1916, the governor of the Commonwealth Bank advised the Treasury that:

> Under the Banking Laws of the Commonwealth at the present time, I do not think there is anything to stop them opening a branch if they care to, although the Commonwealth Bank of Australia could not open a Branch in New York if it desired to.

> I would suggest that a reply be sent saying the Commonwealth Government do [sic] not approve of the opening of a Branch of the National City Bank of New York in Australia. (NAA A6006 1916/6/21)

This failure to get informal government approval was enough to dissuade the bank from entering Australia at the time. NCB did open an office in Sydney in 1926 but closed that office three years later having been denied access to the Australian clearing house by local banks. The Commonwealth Bank further dissuaded NCB from opening in Australia in 1939 (Knowles, Patmore and Shields 2010). In each case banks and regulators were able to prevent the entrance of an international competitor into the Australian market without a formal legislative prohibition.

The 1937 Royal Commission proposed the formal mechanism by which control over entry was to be exercised for the next forty years. The prevention of foreign entrance into banking was one of the major themes of evidence given in front of the commission by local banks (Schedvin 1992). Accordingly, the
Royal Commission recommended that the Commonwealth legislate that no individual or firm carry on the business of banking without a licence or authority from the Treasurer (Royal Commission into Monetary and Banking Systems 1937, p. 250). Existing banks would be provided with licenses immediately. Applications for new banks with a minimum start-up capital level of at least £500,000 would be considered. The use of the word “bank” was to be restricted by law to institutions duly licenced, or to state banks regulated under state law.

For the Royal Commission, licensing served a number of functions. First, it was a privilege which could be withdrawn from a bank “in the event of a wilful or persistent failure to conform” (p. 250) to the new regulatory requirements. Second, the licensing regime created a discrete and unambiguous category of firm on which regulation could be easily imposed. The Royal Commission proposed substantial regulatory controls on firms in the banking business. The question that raised was which firms should be considered a bank for regulatory purposes. Thus the licensing question offers a sort of prehistory of the boundary problem described by Goodhart (2008). Under a licensing regime, a bank is a firm which has a banking license. This definition only avoids collapsing into recursivity by the fact that the ultimate authority to decide which firms received a banking licence was the Australian treasurer, who held the discretionary power to license new banks.

These definitional and conceptual issues around what was considered a bank would not have seemed complex in 1937. The private trading banks in operation at that time were well established. The youngest bank – the Queensland National Bank - had been in operation for 64 years (Royal Commission into Monetary and Banking Systems 1937). The vibrancy of the financial market of the 1890s was just a memory. Merrett (1990) describes the banking sector in the interwar period as a “tightly knit oligopoly”.
The industry had an interest in preventing further market entrance, regardless of whether those new banks were foreign or domestic.

A bank licensing regime was first implemented by the National Security (War-Time Banking Control) Regulations in November 1941. Any bank that was not a bank of the Commonwealth or a state could only operate with the permission of Governor-General. The regulations listed fourteen trading banks which were to immediately receive licenses. Licences would be withdrawn if a justice of the High Court found that a bank had contravened the regulations. Licensed banks had to supply statistics and information to the treasurer, and comply with the special accounts procedures and interest controls detailed in the regulations.

The 1945 Banking Act gave this licensing regime statutory form. Schedvin (1992, pp. 393-4) notes that the restrictions on foreign bank entry were founded on largely unexamined ideological foundations. That bank entry needed to be controlled was:

largely a matter of faith and was only occasionally subject to critical scrutiny. It had its roots in notions about banking and the behaviour of the economic system ... the special role of banks in the provision of services to the community, the potential danger of unrestrained competition in banking, the need for full and effective central bank control over the system, and the risk that additional foreign banks could act as a destabilising influence on the flow of overseas funds to Australia.

Despite the limited size of the Australian market (Merrett 1990), there was a foreign presence in Australian banking. Three of the banks listed in the Banking Act 1945 were foreign banks. The Bank of China was two-thirds owned by the Chinese government and restricted its business in Australia to Chinese visitors and residents. The Comptoir National d'Escompte de Paris and the Bank of New Zealand were fully owned by their home governments (Butlin 1983). These were relatively small banks with...
modest ambitions and long histories in Australia. Long established British banks operating in Australia were also given licences.

In the post-war period a number of approaches were made by foreign banks to operate in Australia. American Express made an approach which was rejected in 1946. As part of Japan’s attempts to re-establish trade relationships with former trading partners, the Bank of Tokyo sought to reopen in Australia in 1952. In 1956 it was granted authority to open a liaison office which was strictly prohibited from conducting banking business. In a letter to the President of the Bank of Tokyo in August 1964, Harold Holt explained the government’s objections to foreign bank branches in Australia in terms that strongly hint at the political factors underpinning the policy. The only way for foreign banks to operate in Australia was through correspondent domestic banks, and Holt was concerned to protect domestic banks’ interests.

We are unable to appreciate ... why the facilities already available are regarded by your Bank as being inadequate for the needs of [Japanese] enterprises. Our experience indicates that there is no lack of preparedness on the part of the existing banks in this country to consider on their commercial merits, subject to general credit policy in operation from time to time, applications for loans by Japanese-controlled enterprises in Australia ... The correspondent banking arrangements work smoothly and there is no evidence that they are inadequate. (NAA M2568 68)

Limitations on foreign bank entry were supported by the Australian Bankers Association (ABA). The ABA argued that new competition would undermine cross-subsidised rural services, that there was no demonstrated need for new bank entrants, and that the introduction of one foreign bank would make it hard to justify not letting in more (Schedvin 1992, p. 397).
7.2.1 Preventing foreign investment in banking

While the Banking Act gave the treasurer power to simply deny the establishment of foreign bank branches in Australia, one potential weakness in the regime was that foreign banks or investors might seek to enter the Australian market by acquiring an existing bank with an existing licence. The government first tried to dissuade foreign investors through suasion rather than law. By such methods, a takeover by Lombard Banking of the Brisbane Permanent Building and Banking Co was prevented in the late 1950s, a merger between the British Chartered Bank and the English, Scottish and Australian Bank and an attempt to merge the Commercial Bank of Australia with a consortium of British, South African and Canadian banks were both prevented in 1963, and the Bank of America was prevented from taking a controlling stake in the Bank of Adelaide in the mid-1960s (Schedvin 1992).

The growth of NBFIs presented another weak link in foreign entry control. In 1966 the First National City Bank of New York (FNCB, formerly the National City Bank of New York) acquired a stake in the Waltons department store retail financing operation. The federal government became concerned that FNCB was trying to enter the commercial banking market through the back door. FNCB prodded other weak-spots in the Australian regulatory framework, creating mutual ventures with an Australian life insurance company, operating in the Australian unofficial money market, partnering with Arnotts Biscuits to create the Arnotts First City Permanent Building Society, and even trying to purchase the London-registered ANZ, which the Australian government would not have been able to prevent.

The regulatory interventions introduced to prevent manoeuvres like those of FNCB are of interest not just in their own right but because of the way they were repurposed and recast as prudential regulations in later decades. The late 1960s saw a bipartisan turn against foreign ownership and investment in Australian firms. John Gorton, Liberal prime minister between 1968 and 1971 saw his relative scepticism
about foreign direct investment as an issue on which he departed from his Coalition predecessors (Henderson 1994; Pokarier 2000). Despite a public reputation and private preference for a liberal foreign investment regime, his successor William McMahon, prime minister between 1971 and 1972, introduced the predecessor of Australia’s modern foreign investment regulatory regime, the Companies (Foreign Takeover) Act in 1972. This gave statutory force to the increasing number of investment restrictions that had been previously imposed through suasion.

In such an environment, more formal restrictions on foreign investment in banking in particular were virtually inevitable. In early 1970 a number of foreign investors took shares in the Bank of Queensland. The bank, a “great and loyal supporter” of the Coalition (NAA A463 1971/1182), lobbied the Gorton government to introduce restrictions on shareholdings and prevent a partial foreign takeover. In May 1970 the treasurer, Leslie Bury, announced that the government was concerned the Banking Act gave the government only limited power over changes in ownership control over banks, and would introduce legislation to prevent a bank “pass[ing] into the hands of financiers who might reinvest the bank’s assets in a manner detrimental to the national interest” (Bennetts 1970). Political instability meant that the Banks (Shareholdings) Bill was only introduced into parliament in May 1971. The Bill placed a limit on shareholdings of a bank at 10 per cent. While the Governor General could grant an exception to that limit, in practice it vested the treasurer with authority to approve or deny any acquisition of shares in a licensed bank which would bring ownership above 10 per cent. The stated justifications for the bill were a mixture of economic nationalism and prudential concerns, illustrating the woolly conceptual issues surrounding bank ownership:

The Government’s policy towards the ownership of banks in Australia is based on the view that banking should be conducted by companies of undoubted financial viability which can be expected to recognise that banking is a business in which the nation has special interests. In addition, it is the
policy of the Government, as it has been of all previous governments since 1945, not to grant
overseas interests authorities to carry on banking business in Australia or to allow them to acquire
interests in existing Australian banks. (CPD, House of Representatives, 6 May 1971, p. 2717)

While in this statement there is a brief suggestion as to the need to ensure that banks operating in
Australia had “undoubted financial viability”, the focus is clearly on the need to keep foreign investment
limited to protect the “special interests” of the nation. The shifting justifications for the Bank
(Shareholdings) Act 1972 and its long, contested legacy will be discussed below.

7.3 Labor and foreign banking
Both the Campbell committee and the Martin Group recommended that foreign banks be introduced
into Australia. For the Hawke government, foreign bank entry was the most sensitive part of the reform
package. Keating argued that the entry of foreign banks would shake up the docile established
Australian bankers. In a clever spin on the old Money Power concern, Keating believed that foreign
bankers would undermine the economic and political dominance of the domestic banks. This was one of
Keating’s great themes about the benefits of foreign bank entry. The domestic banks were “drones”
(The Age, 13 October 1981, p. 31), “dopes ... absolute idiots” and “competition would get them up off
their arses” (Martin 1999, p. 203, see also O’Brien 2015). At the launch of the first of Citibank’s retail
offices eighteen months later, Keating told the Citicorp chairman that he expected the new entrant to
give the existing Australian banks “hell” (Knowles, Patmore and Shields 2010).

Keating’s attitude was not unjustified. In June 1982 the Fraser government was aware of at least 39
foreign banks that had expressed interest in conducting banking business in Australia, dominated by ten
American banks and ten Japanese banks (NAA M880 308). An ABA discussion paper, provided to Howard
just months before the 1982 election, underlines the antipathy to which domestic incumbents saw the
possibility of new foreign competition (NAA M880 104). While accepting that foreign bank entry was
unescapable, the ABA was concerned to slow and limit its introduction. In its view, foreign bank entry “should not be considered” until the rest of the banking sector had been “substantially deregulated”, and until after a “post-deregulation transitional period” for domestic banks to make adjustments to their banking practice. The number of foreign bank licenses should be limited, and the government should ensure that there were reciprocal entry arrangements in those banks’ home countries.

Labor’s national conference was held just a few months after the Martin Group report was released. The 1984 National Conference was one of the Hawke government’s great political coups and a pivotal moment in the story of Australian reform. The proposed ALP platform going into the 36th National Conference in Canberra in mid-July 1984 was to “maintain the existing restrictions on foreign entry to strategic sectors of the economy including banking”. Keating secured the elimination of the phrase “including banking” from the party platform, and a recognition that “the Government will call for expressions of interest in banking licences from domestic groups and foreign banks” (Steketee 1984). Keating’s opponents extracted concessions that these licences would only be granted should a long list of technology, employment, and social policy conditions be met. For example, new licenses would have to:

i. recognise and facilitate union organisation and award coverage;

ii. provide for consultation with unions on technological changes at all levels;

iii. ensure adequate health and safety standards;

iv. provide for equal opportunities for the sexes; and

v. ensure recruitment and training of Australians in areas where foreign banks have special expertise.

Three concessions are of particular interest. First, the National Conference agreement said that only a “very limited” number of new licences would be granted. Yet Keating managed to avoid demands that
the number of new banks be specifically listed as a maximum of six to eight (Steketee 1984). Second, the conference required that “every effort” be made to achieve a 50 per cent equity stake in the new licences. However, the wording of this requirement suggested that foreign equity above 50 per cent was nonetheless permissible. Finally, the conference required that foreign banks establish subsidiaries in Australia, rather than branches, “in order to insulate the Australian entity from any potential problem of the parent bank, including exposure to international debt, and from destabilising flows of funds”.

After the August budget and a prescheduled trip overseas, Keating brought proposals for new banks to Cabinet (Short 1984). On 10 September 1984, Cabinet considered the heart of the Martin Group report with two submissions, presented in tandem, covering banking participation and the entry of new banks (NAA A13977 998; NAA A13977 999). Following the lead of the Campbell committee, prudential questions were subsumed under a more general question of what principles were to govern existing and new entrants.

7.3.1 The conceptual evolution of shareholder limits

The proposals taken to Cabinet in September 1984 demonstrate the tight relationship between bank entry restrictions and prudential policy. The distinction between banks and non-banks were to remain, as depositors needed a safe haven for their funds, banks had a privileged place in the payment system, and the systemic significance of banks demanded prudential controls. Ownership controls introduced by the Banks (Shareholdings) Act were also to remain, albeit with some marginal liberalisation. Where the 1972 act prohibited the acquisition of more than 10 per cent of a bank’s shares, Keating proposed raising this basic threshold to 15 per cent. The Martin Group recommended that only new banks enjoy the new 15 per cent limit, but Keating rejected such a differentiation on competitive neutrality grounds.
In Keating’s view, despite some liberalisation the “general policy presumption in favour of dispersion of shareholdings in banks” should remain (NAA A13977 998).

These seemingly minor adjustments to the Banks (Shareholdings) Act 1972 disguise a transformation in the policy rationale for ownership control. In 1972 the act was explicitly a mechanism to prevent the acquisition of Australian domestic banks by foreign interests - resolving what Schedvin (1992) identifies as a weak link in the 1945 legislation. A decade later the act was being seen as a primarily prudential control. The Keating Cabinet submission stated that the ownership constraint was “largely designed for depositor protection and is an important prudential safeguard” (NAA A13977 998). We can trace this shift back to the Campbell committee, which had described the shareholdings limit as nothing other than a constraint on ownership designed to encourage “a spread of ownership and the avoidance of dominance in control by one or a few interests” that was neutral on the question of domestic or foreign ownership (Committee of Inquiry into the Australian Financial System 1980, p. 295). While accepting that an original justification had been foreign ownership, the Campbell committee argued that this role was now filled by the Foreign Takeovers Act 1975 (Committee of Inquiry into the Australian Financial System 1981, p. 298). In the Campbell committee’s view, general competition law administered by the Trade Practices Act ought to govern ownership questions in the banking sector, and disclosure and accountability requirements ought to be in place to ensure the free working of market discipline in banking. Consequently, the final report recommended that the Banks (Shareholdings) Act be abolished outright.

The Campbell committee did consider the prudential arguments for the shareholdings limit but rejected them on two grounds. First, the limit might offer unwarranted security of tenure to management, with counter-productive prudential consequences. Second, concentrated ownership was more likely to
enhance security than dispersed ownership. Shareholders with more skin in the game were likely to put up capital if the bank was in crisis. Yet, despite having rejected the prudential case for shareholdings limits, the Campbell committee proposed a new power which gave the RBA discretion to require the divestment of shareholdings above ten per cent if the central bank and the treasurer believed doing so would be “in the best interest of depositors” (Committee of Inquiry into the Australian Financial System 1981, pp. 298-9).

Yet the Martin Group claimed that the Campbell committee had, in fact, largely accepted the prudential arguments for shareholding controls, and argued that its proposed divestment procedures were too complex. In the Martin Group’s view, the prudential benefits for dispersed ownership were as follows. Dispersed ownership limited the interdependence of a bank’s fortunes with the fortune of its dominant shareholder. Concentrated ownership could enhance agency problems by encouraging management to act in the interests of shareholders rather than depositors. Finally, dispersed ownership may enhance the ability to raise capital from a broader array of shareholders rather than a few (Australian Financial System Review Group 1984, pp. 57-8).

In this way statutory provisions designed to reduce foreign ownership – the over-riding interest of parliament under the Gorton, McMahon, and Whitlam governments – were reimagined by the Hawke government as a mechanism to protect depositors and the stability of the banking sector as a whole. This is a revealing episode for a number of reasons. The public interest arguments for regulation are malleable. Existing and proposed institutions of social control can be justified in different ways according to the dominant regulatory philosophy of the time.

Yet that reshaped justification was not uniformly supported within the government in late 1984. The Department of Prime Minister and Cabinet was “strongly” in favour of further relaxation of the
ownership controls. The department rejected the argument that shareholding limits were a prudential policy. As it argued in a Cabinet submission, “The general way in which this restriction has operated and the ‘sanctity’ which it has since acquired in some eyes would not appear to be justified, in terms of its original purpose”, and that “a limit significantly in excess of the proposed 15 per cent limit would in fact be desirable” (NAA A13977 998).

7.4 Reconceptualising prudential regulation for foreign banks
The shifting justifications of the shareholding limits is both an example of, and symbolic of, the long term shift in the purposes of bank regulation in general. The “deregulation” period saw many existent controls for the purposes of monetary management or foreign investment restriction reconceptualised as prudential controls. This was partly by necessity. The refusal to grant applications for new bank licenses in the past four decades meant that there were no established prudential criteria under which a licence would be granted, and the Banking Act was silent on this issue. The Treasury recommended to Cabinet that any new bank would require a minimum paid up capital of $25 million. Furthermore, the Treasurer was to be vested with a large degree of discretion to reject applications on character and prudential grounds. Shareholders had to demonstrate to the government’s satisfaction that they were “well established and financial sound entities of standing and substance” who were able to ensure the bank would be able to maintain depositor confidence (NAA A13977 998). Missing from the Treasury recommendations were the stringent social and employment controls insisted on by the ALP National Conference just a few months earlier. Nor was there any trace of the reference to the government’s broader social objectives which had framed the Martin group’s investigations. The Hawke government limited bank regulation in the context of foreign bank entry to focus on prudential matters.

Indeed, it was prudential questions that dominated Cabinet’s consideration of the entry of foreign banks. Treasury argued that one of the primary reasons to allow foreign applications was that the high
level of prudential regulation that would be imposed on new licensees might act as a prohibitive barrier for new domestic entrants:

It should … be recognised that, given the necessarily stringent criteria for entry into banking, the scope for participation of domestic interest in substantial new banking ventures may be limited.

(NAA A13977 999)

No limit on the number of new banks was proposed to Cabinet. Rather, the number of new licences was to be determined by the quality of the application on prudential grounds. Furthermore, the level of foreign ownership in new banks was to be left up to the discretion of the Treasurer. The government did not want the 15 per cent shareholding limit of the Bank (Shareholdings) Act to keep out foreign banks. Neither did Keating wish to be bound by the National Conference’s preference to have 50 per cent or more Australian equity in foreign ventures as “[s]ome leading foreign banks may be difficult to attract on a 50 per cent equity basis” (NAA A13977 999). McCrann (1984) wrote “This gives the Government great flexibility which is highly desirable, as it – and Australia – is stepping into the unknown and it would be foolish to pre-empt itself.”

Six months after opening applications, on 27 February 1985, Keating announced that the government planned to approve 16 new bank licences - more than the eight to ten which had been discussed by Howard as Treasurer, or the four to six proposed by the Martin Group, and all of those licences would be to foreign banks. The key ownership condition imposed was that all foreign banks had to take Australian partners. Many foreign banks had already done so in the hope of making it more likely that their applications would be approved. The one exception to this requirement was Citibank, which had not been required to take a local partner. Knowles, Patmore and Shields (2010) attribute this to a superior lobbying campaign on Citibank’s behalf. Citicorp – Citibank’s parent company – was at that time the
largest bank in the world. It was clear that much of Keating’s hopes for enhanced competition in the sector were resting on its head. Nevertheless, the apparent favouritism for Citibank created some consternation among the new entrants.

Some preview of later tensions was evident from this early stage. The foreign banks had hoped to control about a fifth of the Australian market within five years (Martin 1999). But as they saw it, the large number of new licences that Keating had granted devalued those licences (Hutcheon 1985). Foreign banks had been hoping to share in the monopolistic rents enjoyed by local banks, but ‘Keating’s 16’ made those rents diminishingly unlikely. Another frustration was that the liberalisation of banking practices made those licences less attractive. In early 1984 Keating started approving applications from merchant banks to deal in foreign exchange (Gittins 1984a). This undermined the banks’ exclusive right to participate in that lucrative market. Finally, the RBA decided to impose on the new foreign banks a higher capital ratio than was imposed on existing banks: 6.5 per cent compared to around 5 per cent. This was, in the words of the RBA’s head of supervision, not intended
to thwart competitive aspirations. It was imposed solely for prudential reasons, to provide an extra margin of support for depositors of the new banks while they establish a foothold in the Australian market. As a bank develops a stable funding base and a diversified portfolio of assets, and demonstrates through sound management its status in the local market, the requirement will be reviewed. (Brady 1985)

The new banks placed pressure on the governance of the Australian regulatory system. Since the 1945 Banking Act, prudential supervision was done on informal and advisory terms. It was based on personal relationships between the long established banks and their long established regulator. The foreign banks forced a rethink by the RBA of its approach to prudential regulation. Informal relationships ceded ground to more formal and transparent controls. The changes in regulatory practice in the 1980s can be
classified under three headings: regulatory formalisation, which concerns the drive towards written and distributed rules, regulatory surveillance, which describes the mechanisms of information gathering in the process of RBA supervision, and regulatory reform, which either eliminated or restructured the liquidity and monetary policy management tools that had been instituted in the post-war years. (Capital adequacy standards followed in 1988 and are the subject of the next chapter.)

7.4.1 Formalisation
The introduction of foreign banking was accompanied by less highly publicised but no less significant changes to the longstanding structure of prudential regulation. In January 1985 - that is, just a few weeks before the approval of the 16 foreign banks - the RBA released its first in a series of prudential statements. These constituted a more formal clarification of prudential requirements. The RBA prudential statements started as general principles of regulation but over the course of the decade became more detailed and more highly specified, driven by the need to make clear to the newly competitive banking sector what obligations they had to Australian regulators. Initially, there was a particular emphasis on the risk profiles of new entrants (Tingle 1984). But concern for competitive neutrality meant that a change in the approach to prudential matters for foreign banks necessitated a change in the approach to prudential matters for incumbents as well.

The first prudential statement was a general statement of principles that would govern the prudential supervision of banking in Australia, outlining the need for prudential policy, and foreshadowing "greater formality" in prudential rules. The RBA gave three reasons for this need: the rapid diversification of bank activities and innovation, international prudential coordination (which we shall look at in Chapter 8), and "the entry of new banks may make it more difficult to service effectively a system which relies on close individual consultation".

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Other prudential statements were released over the course of the decade. A second prudential statement (B1) was published in December 1986 and concerned the RBA’s prudential perspective on the ownership controls outlined in the Banks (Shareholdings) Act. This statement offered an argument for shareholder limits in that “the responsibilities on the owners and managers of banks in relation to outsider creditors are of more than ordinary significance” and that it was therefore “desirable that control of a bank be in the hands of a board of directors which is representative of the shareholders as a whole”. Prudential statement C1 was published in August 1988, concerning bank capital adequacy ratios. C1 represented a transformation from statements of principles to detailed rules outlining exactly how the RBA intended to weight bank capital. Other important prudential statements included D1 (on liquidity adequacy, published in February 1990), E1 (outlining the RBA’s expectations about reporting large credit exposures, published in August 1989) and I1 (a March 1985 statement governing access to the payment system by NBFIs).

Written statements of RBA policy were not new. The RBA’s annual reports had long contained summaries of the central bank’s regulatory directives in the exercise of monetary policy. The nature of these directives varied considerably. “Directives have varied from mere indications of the general tenor of current credit policy to the laying down of quite specific targets” (Arndt and Blackert 1977, p. 167). However these written directives were public statements mostly intended for the consumption of non-banks. Banks facing complaints from customers about limited credit availability could point to published directives from the RBA to explain why credit had been refused. These directives also functioned as written public confirmation of the stance of monetary policy, easily understandable by the other economic actors, including, importantly, NBFIs, which in the post-war years the central bank had limited control over. The RBA’s actual regulatory power was exercised not through written statements but in its consultative relationship with the banks.
The new prudential statements differed from these earlier written directives in other ways as well. First, prudential questions had been of secondary importance compared to the exercise of monetary policy. Now with monetary practice largely entrenched in the market and the banking sector newly competitive, the government and the RBA were more concerned than before with the institutions of depositor protection. Second, these prudential statements functioned not as announcements of policy decisions but as formal rules which were to govern the sector. While prudential statement A1 was a broad statement of principles, C1, which introduced the Basel Capital Accords, was a detailed rule book to guide banks through the new risk-weighted capital adequacy regime.

It is true that the regime continued to rely substantially on suasion and discretion. The RBA had the discretion to vary capital ratios according to its assessment of a bank’s credit risk. For instance, prudential statement E1 required the banks to report large credit risks to the RBA with a warning that “a bank wishing to maintain a high volume of large exposures may be required to maintain a higher capital ratio”. RBA officials reflected that “A good deal of importance has been placed on preserving the co-operative nature of the supervisory arrangements” (Thompson 1991, p. 119). Nevertheless the prudential statements were both a practical and symbolic indication of a shift from relationship-focused regulation to rules-based regulation.

7.4.2 Surveillance

One of the most important steps towards regulatory formalisation was delegating surveillance to the bank’s private auditors. Since the passage of the Banking Act, some formal supervision was conducted through periodic audits of bank books by the Auditor General, but the RBA for the most part relied on its close relationships with individual banks to assess regulatory compliance and detect liquidity and
solvency problems. A large number of new banks made this arrangement impracticable (Committee of Inquiry into the Australian Financial System 1981, p. 313).

The solution was to involve the banks’ external auditors in regulatory surveillance. The RBA’s Head of Supervision quoted Samuel Johnson to this effect: “Knowledge is of two kinds. We can know a subject ourselves, or we can know where to find information upon it”. The RBA wanted to “tap all important sources of information about the soundness of banks” (RBA Archives BM-PAC-M-G). In April 1986, the RBA announced it was bringing external auditors into the regulatory nexus (prudential statement H1). This involved a significant change in the relationship between auditors and banks. In the words of one auditor at the time, “We now have a three-way relationship and that, I think, is a new one because it raises the question of whether the banking client is going to be as full and frank if he knows that his auditor is possibly going to make some observations to the Reserve Bank” (Hutcheon 1986b). Regulatory surveillance through this mechanism also required auditors to observe elements of banking practice that they had not previously observed. For example, the auditors had to assess the effectiveness of management, the effectiveness of control systems, make observations about whether prudential requirements were being met not just at audit time but “at all times”, and make judgments as to whether there was anything with “potential to prejudice materially the interests of depositors.”

Delegating regulatory surveillance to the private sector was lower cost from the perspective of the regulators but the cost of the extra auditing requirements was to be borne by the banks themselves. As the Campbell committee put it, “such arrangements could be expected to lessen the burden of supervision on the Reserve Bank” (Committee of Inquiry into the Australian Financial System 1981, p. 314). Yet it was not obvious at the time that auditors were capable of making the sorts of prudential assessments that were required by the RBA. Indeed, Davis (1995) attributes some of the financial
instability of the late 1980s to the fact that the RBA was not adequately supervising the newly competitive banking sector.

7.4.3 From liquid assets and government securities to prime asset requirements

The introduction of foreign banks gave a spur to reforms in regulatory mechanisms that had been proposed by both the Campbell committee and Martin Group reports. The first to be tackled was the liquid assets and Commonwealth government securities (LGS) ratio. The LGS ratio convention had been introduced by the Commonwealth Bank in 1956 as a secondary reserve requirement. The LGS ratio was usually fixed at around 18 per cent. At the time of its introduction, the LGS ratio’s purpose was two-fold. First, it was a monetary tool. In a regime where interest rates were fixed, the LGS ratio was a variable constraint designed to prevent the banks from offsetting the central bank’s credit constraint policies (Valentine 1986). The second purpose of the LGS ratio was to provide a captive market for government securities, one of the most internationally common ways that governments expropriate value from banking regulation (Kroszner 1999). Over time, however, a third purpose for the LGS ratio had been conceived: as a prudential measure. Hence the Campbell committee argued that “bank holdings of government paper should be determined on the basis of interest rate offered rather than any formal requirement (other than prudential)” (Committee of Inquiry into the Australian Financial System 1981, p. 185). The Martin Group took a similar approach (Australian Financial System Review Group 1984, pp. 115-6).

The LGS was abolished in May 1985, a few months before the first foreign banks opened in September. In its place the RBA introduced the prime assets requirement (PAR). This required banks to hold initially 12 per cent of its liabilities repayable in Australia in either notes and coin, deposits with the RBA, Commonwealth government securities, or loans to authorised money market dealers secured against
Commonwealth government securities. The major difference between the LGS ratio and the PAR was its denominator. Where the LGS ratio was measured as a proportion of deposits repayable in Australia, the PAR was all dollar denominated liabilities, excluding capital (Valentine 1986). This was intended to reduce opportunities for regulatory arbitrage. However, one unintended consequence of the initial PAR arrangements was an added incentive to use offshore funding (Shields 1988). Hence in November that year the PAR was extended to foreign currency liabilities used to fund Australian dollar assets (Harper 1988).

The PAR was intended as prudential from its introduction. The purpose of the PAR was to provide a liquidity tranche above and beyond the liquid assets necessary for daily liquidity needs that could be drawn upon in “extreme circumstances” (Reserve Bank of Australia 1990, p. D1). The PAR was set substantially lower than the LGS which it replaced. Nevertheless, the principle that the government ought to engineer a captive market for its own debt remained, and the “taxation effect” that the requirement created also remained (Valentine 1986, p. 247).

7.4.4 From statutory reserve deposits to non-callable deposits

Reform of the LGS was followed by reform of the statutory reserve deposit scheme. Austin Holmes, the longstanding RBA staff member and long-term advocate of deregulation, had campaigned for years against SRDs: in his view, varying SRDs was either ineffective if interest rates were not lifted simultaneously, and unnecessary if they were (Carew 1989). The SRD had also been used as a stealth taxation mechanism on banks in return for their protected status (Committee of Inquiry into the Australian Financial System 1981; Valentine 1986, p. 67). The Campbell committee recommended the retention of a variable reserve ratio as an instrument of monetary policy in the short-term, but suggested that “when the process of deregulation (and the adjustment of the system to it) has been
completed, and securities markets have developed greater depth, there should be little need for an instrument to supplement open market operations” (Committee of Inquiry into the Australian Financial System 1981, p. 74). The Martin Group favoured the retention of a variable reserve ratio as a secondary instrument for circumstances where open market operations might prove difficult or if it was felt that the “announcement effect” of changes in the ratio would enhance monetary policy (Australian Financial System Review Group 1984).

The RBA had reason to be cynical about the virtues of variable reserve ratio requirements. In the 1982-83 Budget, John Howard announced that the government would ask the RBA to release one percentage cent of the SRDs for the special purpose of housing. The idea was originally Malcolm Fraser’s (Errington and Van Onselen 2007) and was one part of what made the 1982-83 budget deliberations so acrimonious (Guttmann 2005, p. 161; Howard 2010, p. 128; Kelly 1984, p. 249). The decision to request the SRD release not only infuriated the Treasury secretary John Stone, but went against the wishes of the RBA as well. There was an internal debate as to whether the board of the RBA was statutorily required to comply with Howard’s request, as not only would such an SRD release would be counter to the direction of monetary policy, but “[m]ore fundamentally, a reserve asset requirement which was perceived to be subject, even in special circumstances, to selective action would very likely lose its effectiveness as an instrument of stabilisation policy” (Bell 2004). The contest over the release of SRD funds for housing was a key moment in the path to RBA independence (Bell 2004). In the short term it had the more prosaic effect of demonstrating to the RBA a weaknesses of direct controls in general: the possibility that they might be used for politically sensitive discretionary purposes contrary to either (what the RBA saw as) the public interest or the original intent of prudential and monetary policy.
All of these factors might have led to reform of the SRD by themselves but further pressure for reform came from the new foreign banks that found the SRD particularly onerous (Hutcheon 1986a). The SRD ratio had been reduced since the 1960s, but, as the Campbell committee revealed, its implicit cost to the trading banks had not declined (Committee of Inquiry into the Australian Financial System 1981, p. 67). The SRD encouraged regulatory arbitrage. Banks sought to avoid the implicit taxation embodied in the requirement by expanding their use of bank bills (Grenville 1991). In its 1986 annual report, the RBA foreshadowed that it would “take opportunities to reduce the ratio when possible”:

The SRD mechanism is not now actively used as an instrument of monetary policy and, with the introduction of PAR arrangements, is higher than necessary for prudential purposes. At its present level it is distorting patterns of financing between banks and non-banks and between domestic and foreign fund raising by banks. (cited in Harper 1988, p. 178)

The decision to eliminate the SRD ratio was announced by Keating in the August 1988 Budget speech alongside the abolition of the long-standing distinction between trading banks and savings banks. The SRD ratio was replaced with a ‘non-callable deposit’ (NCD), set at one per cent of bank liabilities excluding shareholders’ funds. On 27 September 1988 all SRD funds were transferred into NCD accounts, and the SRD excess was returned to the banks over a three-year period (Battellino and McMillan 1989).

The legislation which formalised this change, the Banking Legislation Amendment Bill 1989, was not introduced and passed in the parliament until the next year. The bill, which had been first foreshadowed in the first statement of prudential principles released by the RBA four years earlier, represented a further formalisation of the lines of prudential regulation. It gave the RBA the explicit statutory responsibility for prudential matters that had previously only been implied in the central bank’s
mandate to protect depositors. The bill also represented the integration of Australian prudential regulation with the international regulatory harmonisation discussed in the next chapter.

One further change to the prudential framework came in the context of an election. Early in the 1993 federal election campaign, Paul Keating announced that if re-elected, he would alter the terms under which NCDs were held at the RBA (Keating 1993). Interest on NCDs was paid at 5 percentage points below the Treasury note rate. In February 1993 the weighted average yield on 13 week Treasury notes was around 5.7 per cent. As a consequence the banks were earning less than one per cent on their NCDs. Both domestic and foreign banks argued that NCDs were effectively a $140 million per year tax for the cost of being supervised: “an annual licence fee for their right to practise banking” (Walsh 1993). The government proposed to raise the NCD interest rate to equal the rate on 13 week Treasury notes. This proposed NCD change was however an explicit quid pro quo between the governments and the banks. In return, Keating said, the banks were to increase their lending to small and medium-sized businesses “to the maximum extent possible”. To give some substance to the deal, it would be accompanied by the creation of a “large and representative” RBA advisory committee to focus on bank lending to the small and medium business sector, and a new quarterly survey of businesses to determine whether the financial system was fulfilling their needs (Keating 1993).

Once the election was over and Labor was returned, Keating’s NCD quid pro quo turned out to be more complex than planned. The information about small business lending required was not always available. “For example, the Government wishes to classify loans to firms as "small" on the basis of the number of employees a company has, but the banks often do not keep such information” (Ellis 1993). Despite these issues the NCD change went through on 1 July 1993. The government had benefited from the implicit taxation which the SRD and NCD requirements had imposed. However, in the political circumstances of
a recessionary Australia and in the heat of an election campaign, Keating sought to rewrite the bank bargain (Calomiris and Haber 2014) in order to deliver benefits to a favoured constituency. Ultimately one side of the bargain was harder to enforce than another.

7.5 Conclusion
With the exception of the changes to the NCD interest rate, the removal and replacement of the SRD at the end of 1988 completed the ‘deregulatory’ phase of Australian financial regulation. The formal institutions to constrain banks that had been introduced in the midst of the Second World War had been stripped away. The special accounts – SRDs – had been abolished. Foreign competition had been introduced. The controls that kept sectors of the market apart were greatly diminished – the old distinction between trading banks and savings banks was collapsed, and, with the reduction of interest controls, the competitive advantage of non-bank financial intermediaries was greatly reduced. The salience of the Money Power theory had not survived much past the Second World War. Yet the policies, institutions, and ideas forged in 1945 remained for thirty more years. Under Bob Hawke, the Labor Party took to the 1983 election essentially the same policy towards controls on non-bank financial intermediaries as the Labor opposition leader H.V. Evatt took to the 1954 election. The Campbell committee and Martin Group reports represent a major institutional break from the past.

The purpose of financial regulatory institutions had changed as well. The Banking Act 1945 was conceived in the shadow of the Great Depression and the Labor movement’s belief that the power of the trading banks and the intransigence of the Commonwealth Bank had both deepened the economic slump and led to the fall of the Scullin government. Many in the labour movement saw bank regulation as a prelude to bank nationalisation. Prudential controls were limited and focused on depositor protection. The Fraser and Hawke governments reorientated direct regulatory controls almost solely towards prudential concerns. Monetary policy was to rely on market action. A shift towards prudential
regulation involved widespread deregulation as many of the controls were designed with monetary
goals in mind. From the vantage point of the 1980s, interest rate controls served no prudential purposes
and therefore were eliminated. Similarly, the transition from the LGS ratio to the PAR ratio, and from
the SRDs to NCDs was a consolidation of prudential regulation at the expense of monetary policy. The
captive market for government securities was maintained, but reduced.

However, this shift to prudential concerns also meant that some policies were retrospectively justified
along prudential lines. The restrictions on ownership in the Banks (Shareholdings) Act were originally an
opportunistic attempt to keep foreign investors from taking control of the Bank of Queensland. Likewise
while the LGS ratio had been introduced as a tool to work in concert with SRD reserves for monetary
control, it had, over time, been reconceptualised as a part prudential measure as well. That function was
overlaid onto the PAR. Yet one consequence of this evolutionary and piecemeal approach was that the
holistic assessment of the goals and philosophy of prudential regulation many commentators believed
was lacking in the Campbell report (Hogan and Sharpe 1983; Quiggin 1992) was never carried out. After
the introduction of the PAR, Valentine (1986) pointed out that “in the presence … of a required capital
ratio, a required liquidity ratio is an unnecessary elaboration” even in a world where the central banks
sought to use such ratios as a tool of monetary policy. The ongoing presence of these regulatory
instruments demonstrate a path dependency in regulatory form.

The regulatory changes that accompanied foreign banks can be mapped on the IPF by distinguishing
between two fields of social control. The first, the substantial reduction in state control, was driven by
an increase in the perceived dictatorship costs of limiting bank licences and controlling interest rates:
what Keating saw as the laziness of the established Australian banks. Yet moving to the left on the IPF on
the question of social control of bank entry placed simultaneous pressure on a second field of social
control: prudential regulation. The RBA moved from a highly consultative, informal, discretionary prudential regime to an increasingly formal, uniform, and rules-based framework. These changes coincided with the new emphasis on prudential questions brought about by the experience of the 1970s. In this sense, the Campbell committee had set the stage for prudential regulation to take precedence in the corpus of regulatory controls.

The final contributor to this change was Australia’s integration into an international prudential regulatory settlement - the risk-based capital controls devised by the Switzerland-based Bank for International Settlements. Australia was not the only country implementing regulatory change which opened domestic markets to foreign participants, and this internationalisation of prudential regulation - which accelerated the trend towards formalisation and rules-based regulation in Australia – is the focus of the next chapter.
8 THE INTERNATIONALISATION OF PRUDENTIAL REGULATION: CAPITAL ADEQUACY REQUIREMENTS AND BASEL I

8.1 Introduction

International integration was a driving force behind regulatory change after the introduction of foreign banks. From 1988 onwards, the story of Australian financial regulation ceases to be a purely domestic one and becomes tightly integrated with international developments. This chapter traces the development of international financial regulation and its integration in Australian domestic policy. The regulatory formalisation brought about by the introduction of foreign banks was accompanied by parallel developments on the international stage.

The adoption of the Basel Capital Accords in 1988 represented the most substantial increase in regulatory controls on banking since the 1945 Banking Act. For Australian regulators in the latter half of the 1980s, the Basel Capital Accords (Basel I) presented an off-the-shelf and internationally recognised formalisation of regulatory controls. While not a party to the G10, Australia adopted Basel I almost immediately. The risk-based capital adequacy rules introduced in Australia were developed in large part thanks to the efforts of international regulators. The adoption of Basel I represents a formalisation of regulation brought about by the inability of the RBA to maintain its previous regulatory model.

Yet Australia’s adoption of Basel I has not been well studied. It barely rates a mention in the most substantial history of the Reserve Bank covering this period (Bell 2004). Most scholarly work on Basel I in Australia concerns the practicalities of its implementation (Hogan 1990; Hogan and Sharpe 1990b) or its impact on Australian competitiveness (Li 2010). For all their virtues, these do not study the significance of Australia’s adoption of Basel I in the broader story of financial regulation. None of the political memoirs and biographies of the period, that have done so much to shape our understanding of regulatory reform in the 1980s, account for regulatory changes after the introduction of foreign banks.
But the importance of those changes to our contemporary understanding of Australian political economy is large.

There are three major arguments as to how Basel I was developed and implemented. The first two pivot around the public interest and private interest divide examined in this thesis. In the public interest approach, financial globalisation and financial market deregulation necessitated an agreement on supervision standards. Internationalisation created a form of market failure which required an inter-state solution. National policymakers cooperated to realise mutual gains from international action (Goodhart 2011; Kapstein 1991). The private interest argument emphasises state action on behalf of private banking interests. The inter-state regulatory agreement was driven by the United States and United Kingdom, who were acting on behalf of the British and American banks that would benefit from the adoption of Basel’s capital standards by their French, Japanese and German competitors. Basel I was effectively an international cartel (Kane 1990). In the words of Oatley and Nabors (1998, p. 36), Basel I “is an instance of redistributive cooperation: the creation of an international institution that intentionally reduces at least one other government’s welfare compared to the status quo”. A third explanation for Basel I emphasises the institutional contingency of the agreements. Quillin (2008) argues both the public interest and private interest argument see Basel I as a ‘hard’ law. Rather, Basel I was ‘soft law’: it functioned as a norm-setting agreement. Hence the public interest model overestimates the significance of the Basel I agreement – international coordination for mutual gain was circumscribed by the fact that no compliance mechanism was built into the system – and the private interest model overestimates the potential private gains, as no level regulatory playing field was in fact developed.

Most study of the politics of Basel I has concerned the protagonist nations – such as the United States, the United Kingdom, and to a lesser extent France and Germany – and depicted the adoption of Basel I
as an international contest between these dominant powers (Goodhart 2011; Kapstein 1991; Quillin 2008; Singer 2007). One useful study of the diffusion of Basel I in peripheral countries is provided by Chey (2014). Chey profiles what he describes as three ‘passive adopter’ countries – South Korea, Taiwan, and Japan. He categorises them into insider and outsider passive adopters. Insider passive adopter nations can have a great deal of influence, as Japan did when it unilaterally placed constraints on its ability to adopt regulations which would not act in its favour. Taiwan and Korea however were outsider adopters. Neither were members of the G10. Chey finds that for Korea, Taiwan and Japan, adoption of Basel I was focused on formal compliance: “This formal compliance by banks, however, contributed little to their actual capital soundness, the key objective of the Accord” (Chey 2014, p. 143). In both Korea and Taiwan adoption was delayed, and adopting Basel rules often meant undermining the strictness of existing domestic capital requirements. What international compliance pressure was applied to these passive adopter countries was focused on the nominal adoption rather than effective adoption. Formal compliance was enough to avoid sanctions for failure to comply. “Whether a regulatory authority did commit voluntarily to the Accord was largely affected by the compatibility between the Accord and its existing regulatory arrangements” (Chey 2014, p. 144).

This chapter provides the first political economy account of Basel I adoption in Australia. It emphasises the use the RBA was able to make of the externally created rule framework that was readily adaptable to Australian settings. In order to make this story intelligible, the chapter first details the origins of the Basel committee, the Basel Concordat and the Basel Capital Accords in its international context. The internationalisation of regulation means that any account of the events and contingencies that led to regulatory change in Australia has to include, for example, the failure of the German Bankhaus Herstatt in 1974, and the bailouts of the American Continental Illinois and the British Johnson Matthey Bankers in 1984, as these had as much influence on the trajectory of domestic Australian regulation as the collapse
of the QPBS and State Bank Victoria. This chapter starts by outlining the origins of the Basel committee and the establishment of the Basel Concordat. It then explains how domestic pressures and regulatory innovation in the United States moved towards international harmonisation of capital adequacy standards, and the geopolitical drivers that brought Basel I about. The second half of the chapter returns the attention to Australia to first explain the parallel development of capital adequacy requirements in the wake of the Campbell committee, and finally how domestic pressures led to the rapid adoption of Basel I. It then considers the special challenge of foreign bank branches as a case of international harmonisation. Finally, the chapter provides an explanation for the adoption of Basel I through the models of political economy studied in this thesis.

8.2 First steps: the Basel committee and the Basel Concordat
The Basel process of regulatory harmonisation was born of the economic uncertainty created by the end of the Bretton Woods agreement, particularly the uncertainty of how floating exchange rates would affect the stability of the financial sector. The catalyst for international prudential regulatory cooperation was the collapse of a German bank, Bankhaus Herstatt, in the 1973-74 economic crisis. Given the significance of this collapse for later developments, it is worth describing the events involved in that failure. Bankhaus Herstatt, founded in 1955, was one of Germany’s largest private banks. It was badly over-extended in the foreign exchange market and suffered from the exchange rate volatility of the first half of 1974. In June that year, German banking authorities investigated rumours of losses and discovered that the Herstatt had been concealing, against German law, losses which amounted to more than half the asset value of the bank. German regulators withdrew the Herstatt’s banking licence at 3:30pm on 26 June 1974. This was the end of the German banking day and after which all payments in Germany would be settled (Becker 1976; Herring 2003). However, the time difference between Germany and the United States meant that the end of the banking day in Germany was the start of the
banking day in New York: 10.30am. Herstatt’s dollar spot contracts were not to be settled for six hours. Herstatt’s correspondent in New York, Chase Manhattan, stopped payments immediately. As Herring (2003, p. 6) writes, “this was a shock to market participants who had previously failed to recognize the credit risk implicit in the normal procedures for clearing and settling foreign exchange transactions that span multiple time zones.” This led to a seizing up of the foreign exchange market (Goodhart 2011). The risk created by international settlement timing is now often described as Herstatt risk.

In June 1974, the G10 governors met in Swiss city of Basel to discuss the Herstatt collapse and where the prudential responsibility for banks operating across international borders ought to lie. The issues included which nation ought to provide lender of last resort, whether Swiss banking secrecy laws had been implicated in the Herstatt collapse, and under what principle failed institutions should be bailed out. The meeting was largely inconclusive. The failure of the G10 to reassure markets contributed to the deepening financial crisis (Goodhart 2011). A further series of meetings was held in early September 1974. At the conclusion of the last meeting on 9 September the G10 announced an agreement to “intensify the exchange of information between central banks on the activities of banks operating in international markets and, where appropriate, to tighten further the regulations governing foreign exchange positions.” Such cooperation was to be based at the Bank of International Settlements (BIS), in Basel, were the meeting had been held. The BIS was seen as a non-political, technocratic body which could examine prudential matters without undue political interference.

Accordingly, the first meeting of the Basel Committee on Banking Supervision (BCBS) was held in February 1975. The members were Belgium, Canada, France, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States and West Germany. The BCBS was formed under the auspices of the BIS, and integrated an earlier informal working group, the Groupe de Contact, which had
been formed by the number of mid-sized continental European countries as a contact point for cross-border supervision. The G10 hoped that the BCBS would provide an “early warning system” (Singer 2007, p. 39) for future financial instability, and an institutional structure by which crises could, if not averted, be at least anticipated. By June 1975, the BCBS had reported back to the Governors of the G10 that this goal was impracticable. Even if national regulators were able to predict such crises, the challenge of accumulating that information at an international level was too daunting. The BCBS directed its attention instead towards recommending improvements to national regulatory schemes and smoothing the information transfer between home regulators and host regulators about the action of bank subsidiaries (Goodhart 2011).

Neither international regulatory harmonisation or the implementation of uniform capital adequacy controls was on the agenda in the BCBS’s first decade (Goodhart 2011). Initially the committee was focused on the supervision of international subsidiaries. In 1975 the BCBS released their principles by which banking supervision should be governed, the Basel Concordat. The overarching principle was that “no foreign banking establishment should escape supervision”. Primary responsibility for supervision was vested in the host regulators, as legally independent entities. Liquidity, solvency and foreign exchange arrangements of subsidiaries operating in foreign countries were to be regulated according to the laws of the host country, rather than the parent country. For the purpose of liquidity controls however, foreign branches were to be regulated by the parent regulator, as “liquidity cannot be judged in isolation from that of the whole bank to which it belongs”. While these conclusions largely reflected existing practice, the Concordat formalised joint responsibility for information sharing, and joint supervisory recommendations, such as direct and indirect inspections of foreign establishments by host authorities (Basel Committee on Banking Supervision 1975).
After the July 1982 collapse of the Banco Ambrosiano in Italy, when Italian authorities provided support for depositors of the Italian bank, but refused to extend any such support to the Banco Ambrosiano’s subsidiary in Luxembourg through which it conducted its Euromarket activities, the Concordat was revised. After the collapse, the Italian authorities argued that the Luxembourg subsidiary was not a proper bank, a view which had not been shared by Luxembourg regulators (Kapstein 1991). The Basel Committee’s delineation of responsibility had been shown to be inadequate and unclear. The revised Concordat, published in 1983, stipulated deeper host-parent solvency supervision of foreign establishments but nevertheless kept the onus on host countries.

Early BCBS work was driven by its assessments of what was politically and practically possible. For example, considering the BCBS’s origins in the Herstatt crisis, it might be assumed that the most urgent role for the BCBS might be developing principles to manage cross-border crises caused by the collapse of an international bank. Yet the Concordat sought no arrangement of lender of last resort facilities (Heffernan 2005). Goodhart (2011, p. 380) concludes that “national procedures of crisis management were too different and idiosyncratic, and the subject matter too delicate to be taken by the Committee”. Nevertheless, early developments of the BCBS were substantial if we consider that, prior to its formation, there was effectively no communication, let alone coordination, between financial regulators internationally. “With the Concordat and consolidation, the central bankers had taken the first step toward international regulatory cooperation and established a foundation for future efforts” (Kapstein 1991, p. 8).

8.3 The Basel Capital Accords
Capital adequacy was first raised as an issue for the G10 in early 1980, when the G10 central bank governors released a communiqué expressing concern about the rate of international lending and the effect regulatory competition was having on domestic monetary and prudential policy:
differences in competitive conditions between domestic and international banking that arise out of official regulations and policies stimulate growth of international bank lending in general; and that transactions channelled through the Euro-currency market can pose problems for the effectiveness of domestic monetary policy in those countries where such differences are particularly significant. The Governors will continue efforts already being made to reduce the differences of competitive conditions, fully recognising the difficulties arising from differences in the national structure and traditions of banking systems. (Goodhart 2011, p. 147)

The economic downturn of the early 1980s pushed capital adequacy harmonisation closer to the top of the BCBS priorities. The spark for Basel I came from North America rather than Europe. American banks were highly exposed to the 1982 Mexican debt crisis. The Reagan administration sought to use the International Monetary Fund (IMF) as a conduit by which it could bail out both American banks and Latin American governments sympathetic to the United States. However this required convincing a hostile Congress that the IMF’s lending quotas should be increased. For the administration, pursuing a bail out through the IMF dispersed the cost of bailing out American banks and would not appear as a burden on the US budget (Oatley and Nabors 1998; Vaubel 1994). Faced with the administration’s $8.4 billion request, Congress insisted that the administration also bring forward a proposal for to regulate American banks to prevent future crises. As one Senator put it, “the price of $8.4 billion in the Congress is going to be legislation ... so we can go home and say we didn’t bail out the big banks” (Kapstein 1991, p. 12).

The focus on capital adequacy was drawn out of the subsequent Congressional debate. American banks and their political allies insisted that higher regulatory burdens imposed on American banks would put the sector at a disadvantage against international competitors. The Chair of the Federal Reserve Paul Volcker brought a scheme for the supervision and regulation of international lending to Congress in April
1983 which featured stronger supervisory controls on American banks, special risk reserves, and strengthened increased regulatory cooperation through the IMF, although this latter proposal was not specifically focused on capital adequacy. Congress responded with the International Lending Supervision Act (ILSA). This act included most of the Volcker plan, as well as a protectionist measure that bank lending officers submit feasibility plans for to bank management for foreign loans about $20 million (Vander Schaaf 1987). Of most long term significance, the bill also required “governments, central banks, and regulatory authorities of other major banking countries to work toward ... strengthening the capital bases of banking institutions involved in international lending” (12 U.S. Code § 3907 (b)(3)(c))

8.3.1 Explaining the Capital Accords

Why did Congress put so much stock in international capital adequacy coordination? Supporters of international action argued that the lack of international regulatory coordination rewarded national bank industries with lower capital adequacy ratios, to the detriment of the stability of the banking system itself. In particular, it was widely believed that Japanese banks were taking market share from American banks due to their lower cost of funding and higher leverage (Kane 1990; Kapstein 1991; Oatley and Nabors 1998). Between 1960 and 1980 the market share of American banks exceeded that of Japanese banks by ten percentage points. By 1985 however that gap had decreased to three percentage points (Oatley and Nabors 1998). The US banks and Congress thought that raising Japanese capital adequacy ratios to that of American banks would reduce Japan’s competitive advantage.

However, Japanese banks had high levels of market-value capital, whereas American observers focused on Japan’s low book-value capital. Taking into account these “hidden” reserves increased the Japanese banks’ capital-to-assets ratio from 2.11 – one of the lowest in the developed world – to 12.35, substantially exceeding all its major competitors (Kane 1990; Wagster 1996). Hence Volcker insisted
throughout the process that the United States’ existing capital adequacy requirements were adequate to the task, urging Congress “not to react with excessive regulations” (Oatley and Nabors 1998, p. 44). Kapstein (1991, pp. 13, n. 2), despite for the most part defending a public interest explanation of the Basel capital accords, makes it clear that “international convergence of capital-adequacy standards was put on the table by Congress rather than by the regulators”.

That ILSA and subsequently the BCBS’s interest in capital adequacy came from Congress rather than disinterested regulators does not of course preclude the possibility that there was a market failure in capital adequacy ratios that uncoordinated domestic regulation was failing to address. Nevertheless, Oatley and Nabors (1998) conclude that American banks’ weaknesses came not from international competitive pressure but their exposure to less-developed countries. Banking systems with lower apparent capital ratios were less exposed. It is also possible that American regulators’ reluctance to pursue international capital adequacy was an attempt to protect their turf. However, as Quillin (2008) reminds us, the discretionary powers of national regulators were only marginally affected by Basel.

The passage of ILSA completely changed the dynamic at the G10 governors meeting and the Basel committee. A subgroup formed within the BCBS in 1982 for the purpose of working on capital adequacy coordination had not proceeded much past accounting for differences in capital definitions. In March 1984 Volcker presented a paper to the G10 governors’ thirteenth meeting requesting the BCBS’s work on capital coordination “be given a new impetus” and that the governors determine a measure of “functional equivalence” of capital on which an agreement could be based (Goodhart 2011, pp. 155-6). This neat phrase obscured a whole raft of problems. In the G10 there was great divergence about the domestic definition of capital. Japanese regulators defined capital as equity capital and reserves. American regulators defined capital as common stock, preferred stock, profits and profit participation.
Swiss regulators included paid up capital, published reserves, limited subordinated debt and general bad debt provisions. Some countries rated assets according to risk, while others did not. Minimum adequacy ratios varied substantially (Quillin 2008).

8.3.2 The development of risk based capital adequacy

The Congressional push for international capital coordination coincided with a substantial change in the attitude of American regulators to capital adequacy. Just as in Australia between 1976 and 1985, regulatory changes were driven by the confluence of institutional change and economic crisis. Until the early 1980s, capital adequacy was assessed by federal regulators on a case by case, institution by institution basis, taking into account factors such as management quality and earnings history when determining a bank’s overall soundness. In the late 1970s and early 1980s regulators were developing more formal approaches, in part to bridge information gaps between the many different agencies with supervisory roles over the banking sector. The first instigator of change was institutional. In February 1983 the federal Fifth Circuit Court of Appeals overturned an order given by the Comptroller of the Currency to the First National Bank of Bellaire that it should increase its capital levels to compensate for management quality: “[r]easons which are in substance mere rhetoric are not sufficient and indicate arbitrary action” (First Nat. Bank of Bellaire v Comp. of Currency (1983) 697 F.2d 674) This decision brought into question long-standing regulatory practice and made the development of formal rules a necessity (Norton 1988). The second instigator was the FDIC bailout of the nation’s seventh largest bank, Continental Illinois in 1984. The American banking sector in the mid-eighties was in a major crisis. In the 1960s and 1970s typical yearly bank failures had been in the single digits (Singer 2007). In 1984, 80 banks failed. In 1985, 120 banks failed. In 1986, 145 banks failed. These failures resulted in a sharp increase on FDIC disbursements.
The combination of an economic crisis and legal demand for formalisation led Paul Volcker and Gerald Corrigan, President of the Federal Reserve Bank of New York, to work towards a formal approach to capital adequacy that would rate assets by risk, rather than the gearing ratio approach that was the feature of early formal capital requirements (Vernon et al. 1991). The Comptroller of the Currency and the FDIC were also looking at risk-based ratings. Under a risk-based rating, assets are weighted for the purposes of capital adequacy regulation by their underlying riskiness. Less risky assets require less capital to back them up. Assessing capital adequacy by risk was not new to the American regulatory environment; risk weighting had long been a feature of the case by case soundness assessments. But in the formalised rule system required by *Bellaire*, risk ratios offered the nuance of the older approach with the certainty of black letter law.

In January 1986 American regulators produced a joint proposal for risk weighted ratings of assets and off-balance-sheet items domestically. There were to be four tiers of risk weighting. Risk-free assets such as cash and one-year Treasury securities were given a 0 per cent weighting. Money market risk, including long term Treasury securities, other government-guaranteed loans and legally binding claims were given a 30 per cent weighting. Moderately risky assets such as state and municipal securities, claims on developed countries were weighted at 60 per cent and all other loans were rated at 100 per cent. The reaction of the American banking sector to this proposal was openly hostile, as they were concerned it would harm the banks’ competitive advantage with the American NBFI sector (Vernon, Spar and Tobin 1991).

8.3.3 Geopolitics and the Capital Accords

Congress had sparked international action on risk-based capital adequacy, but that action was expected to be a slow road. As late as the end of 1986 the BCBS was tamping down expectations for progress
(Quillin 2008). The solution that a frustrated Volcker found for resolving the deadlock was to establish a bilateral agreement with the United Kingdom on capital adequacy. From the American perspective, this manoeuvre was a strategic attempt to pressure the BCBS to finalise an international agreement. From the British perspective, a bilateral agreement with the United States offered countervailing pressure against the European Community, which was then in the preliminary discussions of its own capital agreement as part of its broader regulatory harmonisation program, an agreement that might disadvantage British banks (Kapstein 1991). Capital adequacy was a pressing political issue in the United Kingdom as well. The 1984 bailout of Johnson Matthey Bankers was as embarrassing for the British regulators as Continental Illinois had been for the American regulators (Singer 2004).

The British-American bilateral agreement was quickly negotiated. First proposed in July 1986, it was “virtually complete” by October (Vernon, Spar and Tobin 1991, p. 144). The basic feature of this agreement was its adoption of a two-tiered system, which would give each country enough room to adopt the agreement to its existing regulatory framework. Tier 1 capital was high quality capital, a definition agreed on by both British and American regulators, which would be immediately available to meet bank losses. Tier 2 capital consisted of lower quality, yet still available, capital. Disputed forms of capital were allocated to Tier 2. This distinction allowed both coordination and national divergence, and it became a core feature of the final Basel I agreement. The agreement also featured a variant of the risk-weighted system developed by the American regulators a few months earlier, although this time with five categories of risk weighting (0, 10, 25, 50 and 100 per cent). Off-sheet balance items were included in capital determinacy calculations. No minimum capital level was agreed to, but there was a public intention to do so in the future.
The bilateral agreement was a “bombshell”, as one member of the BCBS investigating capital adequacy put it (Vernon, Spar and Tobin 1991, p. 146).

If the British and the Americans would, as they might, refuse to accept foreign banking establishments into London/New York unless they agreed to abide by the UK/US requirements, then all the international banks would have to do so, willy-nilly, whatever their own national regulations might require. In short, it was essentially a power play, to overcome resistance at the BCBS which was based on consensus. (Goodhart 2011, p. 170)

Kapstein (1989, pp. 340-1) notes that “the tacit threat of preventing foreign banks from expanding operations or establishing new ones within that zone was apparently credible enough to move discussions to the multilateral level”. Japan, whose banks were trying to enter the London and New York markets, felt this pressure keenly.

The head of the BCBS, Peter Cooke, managed to obtain a promise that the United Kingdom and United States would delay their final bilateral agreement to the end of 1987 (Vernon, Spar and Tobin 1991). Progress towards the multilateral accord proceeded that year on a double track. The BCBS worked to prepare their capital accord. At the same time the United States and United Kingdom pursued a trilateral agreement with Japan. Throughout 1987 the British, American and Japanese authorities came to an agreement about common capital standards. This involved a number of concessions from the United States; most notably moving loan-loss reserves to lower quality Tier 2 capital, which necessitated substantial new capital raising by American banks (Vernon, Spar and Tobin 1991). The Japanese, for their part, managed to get agreement that 45 per cent of the unrealised gains on their hidden reserves would count as Tier 1 capital (Kapstein 1991). The final trilateral agreement “reflected Japanese preferences to a significant extent” (Chey 2014, p. 142). The political significance of this agreement, kept secret, was that the British, American and Japanese delegations were able to act as a bloc when the BCBS
considered a global agreement in September 1987. “It did not take long for the other members of the committee to realize that they were faced with a *fait accompli*” (Vernon, Spar and Tobin 1991, p. 150). The preliminary Basel I agreement released for public comment in December 1987 reflected in very large part the trilateral agreement. In June 1988 the final agreement was reached. The major change between the trilateral and Basel I was a further concession to American banks, that preferred stock for bank holding companies be moved from Tier 2 capital to Tier 1.

The final document, International Convergence of Capital Measurement and Capital Standards (Basel Committee on Banking Supervision 1988) was known at the time as the Basle 1988 Capital Accord. In fact it was really concluded in 1987 (Goodhart 2011). Basel I set a common minimum capital to weighted risk assets of 8 per cent. Tier 1, or ‘core’ capital, constituted equity and published reserves. All other forms of capital (such as Japan’s hidden reserves, loan-loss reserves, and subordinated debt) were placed in Tier 2, which were not to exceed 50 per cent of the total capital base. Basel I also risk weighted assets. The justification for doing so was as follows:

I. it provides a fairer basis for making international comparisons between banking systems whose structures may differ;

II. it allows off-balance-sheet exposures to be incorporated more easily into the measure;

III. it does not deter banks from holding liquid or other assets which carry low risk. (Basel Committee on Banking Supervision 1988)

There were five classes of asset risk (0, 10, 20, 50 and 100 per cent). The committee noted that “weightings should not be regarded as a substitute for commercial judgement for purposes of market pricing of the different instruments”. The goal was full implementation in G10 member countries by 1992.
8.4 Basel I and capital adequacy in Australia

Australia was not a member of the G10, and was not a party to the international negotiations on capital adequacy standards whether under the auspices of the BCBS or the bi- and trilateral agreements.

Nevertheless, Australia was one of the most rapid adopters of the new framework. The month after the draft publication of the Basel I in December 1987 the RBA released its own draft proposals based on the Basel I formula (in January 1988). By August 1988 these had been finalised and formally adopted in prudential statement C1, “Capital Adequacy of Banks”. Australia was a non-G10 country and under no geopolitical obligation to implement the Basel agreement early, but did so with speed.

The puzzle is deeper given the RBA was not very involved with the BIS. Australia’s relationship with the BIS dated back to 1967, when the RBA first placed a US$3 million deposit in the European bank. This was done primarily to establish a relationship with the BIS. In 1970, the RBA became a member of the BIS by taking 8,000 shares at the cost of AUD$2.3 million. By 1974, the RBA was holding approximately 10 per cent of its gold and foreign exchange holdings with the BIS (RBA Archives 06/27291).

Nevertheless, despite this financial relationship, Australia was reluctant to involve itself deeply with administration of the BIS. The RBA’s investment relationship was “arbitrary”, and its primary interest in the BIS was as a forum for “economic intelligence” and to utilise its banking services (RBA archives ID85-01892). Even as late as 1986, when the role of the BIS in regulatory coordination had long been established, the RBA was cautious about over-involvement. In large part this was over concern about the distance between Australia and Switzerland and the travel burden that increased involvement would place on the RBA governor. While it saw deeper involvement in the committees and working parties that developed co-operative policy as beneficial, it rejected the option of seeking board membership, and considered that the most important work done by the BIS was reflected by the G10, to which Australia was not a party (RBA archives ID90-02403).
8.4.1 The parallel development of capital adequacy standards

What brought Australia to Basel I was its own parallel interest in capital adequacy. By the mid-1980s, capital adequacy had been high on the mind of the RBA for at least a decade. The Campbell Committee’s contribution to the capital adequacy discussion was that capital “should be seen as the cornerstone of prudential regulation” and the RBA should impose capital adequacy requirements (Committee of Inquiry into the Australian Financial System 1981, p. 301). The Campbell committee recommended that capital ratios be individually applied to banks and determined by a similar variety of factors as the American CAMEL (Capital adequacy, Assets, Management capability, Earnings, Liquidity) system. A ratio would be determined by the RBA according to published criteria but with a great deal of discretion for supervisory purposes. In this, the proposal was to continue the long-standing prudential practice of informal supervision.

As well as these discretionary controls, the Campbell committee recommended the adoption of “risk asset limits”, which would prohibit certain assets from constituting a dominant proportion of a bank’s asset base. The Campbell committee recommended Australia follow the practice of Denmark and West Germany, where fixed limits on loans to single customers were prohibited from exceeding 35 per cent and 75 per cent of capital respectively. This was to be a hard regulatory limit, unlike in the United Kingdom, which imposed reporting requirements on large loans but no strict controls. Similar controls were to be placed on controlling shareholders. The committee also recommended that certain classes of high-risk assets and foreign exchange exposure be controlled. In the former category, the committee argued that “The traditional volatility of property markets suggests the need for a cautious approach to bank involvement in certain classes of property.” Therefore, it suggested the RBA ought to impose risk asset limits on the aggregate amount of “low or non-income-producing property of a developmental or speculative nature” (Committee of Inquiry into the Australian Financial System 1981, p. 305). While the
Campbell committee claimed to favour black letter law on broader questions of capital adequacy, the speculative property requirement would have necessitated a substantial surveillance and discretionary control. Hogan and Sharpe (1983, p. 149) wrote that the discretion vested in the Reserve Bank to determine overall capital ratios for individual banks was “autocratic and indefensible”.

The discussions about capital adequacy at the RBA in the late 1970s and early 1980s closely followed the Bank of England’s efforts in the reform of the UK Banking Act. The Bank of England described its approach as “progressive, participative and personal”, emphasising the close relationship between bankers and regulators, which was underpinned by regular formal interviews between Bank of England officials and private banking staff. The RBA observed that for Australia to adopt the Bank of England’s proposed capital adequacy approach would mean a substantial increase in information provision from the banks (RBA archives FI85-00305).

Throughout 1982 the RBA informed the private banks that it would consider a capital ratio adequate at 5 per cent of total liabilities for individual banks and for associated groups on a consolidated basis. “Banks are inclined to resist our judgment”, one RBA board memorandum noted. The banks argued that a 5 per cent ratio “would place Australian banks in an unfavourable position relative to banks in other countries” (RBA archives FI85-00305). The RBA did not accept those arguments, and held to the 5 per cent ratio. Under the 1982 proposal, banks which fell below the 5 per cent capital ratio would be required to develop “firm plans” to strengthen their capital. In keeping with the consultative supervisory practices of the past, other capital ratios, as well as asset and management quality were also a consideration.

More intensive regulatory interest in capital adequacy ratios was flagged in private discussions between the RBA and the major national banks in 1983. That more formal discussion of capital adequacy was
triggered by the separate decisions of Westpac and ANZ in April 1983 to raise US$100 million of subordinated debt in Eurobond markets. In January 1984, the RBA distributed a paper on the measurement of capital adequacy, following the recommendations of the Campbell committee. The paper emphasised that the RBA’s preferred approach to capital adequacy assessments would be discretionary and “eclectic”:

A degree of flexibility is needed in administering any capital ratio guideline. A uniform capital ratio could not be expected to fit neatly the circumstances of individual banks, or perhaps of a bank as between one period and [sic] other. For example, it would be expected that a new bank, without an established financial record, would need to observe, during its formative years, a higher capital ratio than banks with established financial records. At the same time, where a group of banks is broadly homogenous as regards their structures and operations, e.g. the major private banks in Australia, a common capital ratio guideline could be an appropriate starting point. (RBA archives Fi85-00305)

This reasoning was later used to differentiate capital adequacy between new bank entrants to Australia and domestic incumbents, which as we shall see became one of the political drivers towards Basel implementation four years later. In 1984 the RBA was sceptical about risk weighting assets for the purpose of capital adequacy ratios. While accepting that “the theoretical arguments ... are appealing ... the costs may outweigh the benefits.” First among these costs was the practical difficulties in determining risk weightings, which was essentially “judgmental”, a “heavy task”, and which increased the risk of misjudgement and therefore regulatory error (RBA archives Fi85-00305).

8.4.2 The adoption of Basel I in Australia

The RBA’s perspective on risk weighting changed rapidly as the institutional environment in which prudential regulation was formulated shifted with the introduction of foreign banks. As Paul Keating had expected, the release of sixteen foreign bank licences precipitated a large change in Australian banking
practice. Half a century of protection and financial repression had inculcated a distinctly conservative culture within Australian banks. This conservatism was abandoned after deregulation. The end of credit rationing spurred a wave of innovation driven by the new demands of competition. Between 1980 and 1989, automatic teller machines, variable-repayment home loans, credit cards by Visa and Mastercard, EFTPOS, telephone banking, equity mortgage loans, and compounding term deposits were introduced widely. The competitive dynamic of the banking sector had permanently changed.

Deregulation exposed banks to greater risk. Financial prices became more volatile and banks had to worry about funding their asset portfolios. In addition, competition induced banks to venture further along the risk spectrum in their lending than they ever had need to under regulation. Borrowers who would never have obtained bank finance under regulation were suddenly feted by bankers keen to lend them money. (Harper 1991, pp. 82-3)

Yet the inherited conservatism of four decades had a deep legacy. The same managers who had been rationing loans under financial repression were now facing declining margins and seeking out riskier loans under deregulation. Nor were the internal processes of the domestic banks well suited to manage high risk lending. The result was a large growth in bad loans and bad debts. Bob Hawke (1994, pp. 254-55) wrote of the “breath-taking recklessness” of the banks as they struggled against each other for market share, and that “many financial operators were slow to adapt their prudential requirements to the new environment [which] exaggerated the boom and exacerbated the downturn.”

The post-1985 regulatory framework was unstable. In this context, Basel I offered the RBA a modern, uniform, competitively neutral regulatory framework which could be adopted largely off the shelf, and which was accepted as legitimate by the new bank entrants and domestic banks alike. Such acceptance was particularly sensitive as the new banks chafed at what they saw as the RBA’s onerous and unfair approach to supervision. Particularly frustrating was the 1.5 percentage point difference in capital
adequacy requirements imposed on the foreign banks. As one British entrant was reported to have said, “it’s not a very popular requirement among new banks – it prevents competition on equal grounds. If Westpac went to London they wouldn’t face any different conditions from English banks. But this is Australia and we have to accept the rules here” (Cassie 1986).

Throughout the 1970s, the RBA had been kept informed of the progress of the BCBS’s work on supervisory co-operation, but engagement was limited. In 1976, having received a paper from the BCBS on international co-ordination on cross-border bank failures, the RBA responded that it had “no specific comments” on the contents of the paper, although it encouraged the continuation of the work. Internally, there was concern about the confidentiality implications of information sharing between banking regulators (RBA archives BIIU-U-14). The low level of engagement with the BCBS reflected the relatively isolated Australian banking market.

The introduction of foreign banks changed the RBA’s attitude to international cooperation. Campbell committee representatives met with the BIS during their deliberations (Committee of Inquiry into the Australian Financial System 1981, p. 833). Early in the deregulatory period the RBA sought to adopt BCBS principles as its own. The structure of foreign bank licences was derived from the principles of the 1983 revised Concordat. The RBA insisted that the new bank entrants were locally-incorporated, had legal independence from their parents, and had adequate capital. They were regulated as independent entities according to Australian prudential standards. This was framed by the RBA as respecting the Campbell committee’s doctrine of competitive neutrality, but also respecting the principles of the Concordat (Brady 1985). As the RBA Governor Bob Johnston (1985, p. 574) said, “[w]hile the Concordat has no legal force in any country ... the Reserve Bank supports the thrust of the Concordat, and we have told the Basle Committee that we will have regard to its recommendation in our supervisory work.”
In February 1988 the RBA released proposals for capital adequacy based on Basel I, and released its prudential statement, 'Capital Adequacy of Banks' in August 1988. The RBA regulations hemmed closely to what had been negotiated in the BCBS, but there were a few antipodean variations on the Basel I foundations. Basel I was a framework, not a statute, and national authorities had to make a number of decisions about how to risk-weight various assets. One particular concern for the RBA was how Basel I treated subordinated debt. In its initial discussions concerning capital adequacy the RBA had been critical of the use of subordinated debt as such funds were only available after the bank had failed, and could not meet the loss-absorption necessary to be considered capital. When Westpac and ANZ raised funds in Europe in 1983 the RBA reiterated its position that subordinated debt was not to be included as capital (RBA archives FI85-00305). Thus the inclusion of subordinated debt in Basel I capital adequacy ratios was contrary to the RBA’s position established earlier that decade. In 1988 the RBA adopted a stricter approach to subordinated debt than the BCBS, limiting the committee’s acceptance of subordinated debt with an original maturity of five years as Tier 2 capital to seven years. A further distinction concerned mortgage backed securities. Where the United States and the United Kingdom had risk-weighted residential mortgage backed securities at 50 per cent, the RBA chose to weight them at 100 per cent (contrasting with the 50 per cent weighting for direct residential mortgage loans). This decision potentially biased Australian banks against the development of secondary mortgage markets (Hogan and Sharpe 1990b).

Basel I offered member states a transition period to the new arrangements, which had to be fully implemented by the end of 1992. (An interim standard had to be met by the end of 1990.) Yet the RBA eschewed any such transition, seeking to adopt the new standards immediately. A fixed deadline for compliance was set at 30 September 1988. A transition period for individual banks was only available at the RBA’s discretion. Nevertheless, the Australian banks found the new capital adequacy requirements
relatively simple to comply with. Thompson (1990) noted at the time that most Australian banks already satisfied the 8 per cent risk-weighted capital ratio, and all banks held the 4 per cent core capital required by Basel I. In the event, all banks under RBA supervision achieved Basel compliance by June 1990.

8.5 Foreign bank branches under Basel
The BCBS provided a framework under which further entry liberalisations could be managed. In his One Nation economic statement in February 1992, Paul Keating announced that foreign banks would be permitted to open branches into Australia. Where in 1985 the Hawke government had approved a limited, if expansive, number of new licences contingent on banks incorporating in Australia, in 1992 the further step was taken of removing that absolute limit on numbers and allowing foreign banks to open branches in Australia, without having to establish subsidiaries.

The decision to allow foreign bank branches into the Australian banking market created a range of policy complexities. The 1983 revised Basel Concordat outlined general principles by which supervisors should approach foreign banks. For solvency questions, the Concordat suggested that primary responsibility was given to the home country regulator. By contrast, liquidity needs were more determined by local conditions, and therefore host country supervision was required. Nevertheless, in both cases, the BCBS emphasised that responsibility for prudential matters was a matter of joint responsibility between home and host countries. The Australian approach closely followed the Concordat’s recommendations.

Applications for branch licences would only be considered if the RBA was satisfied that the bank was regulated adequately in its home country. The RBA told the foreign banks that “the quality of home supervision was to be a factor in decisions about branch banking applications” (RBA archives SD-95-01860). Furthermore the home country supervisor had to be compliant with Concordat principles as well.
Thus adherence to the Concordat meant that foreign bank branches were exempt from the requirement to adhere to Australian capital adequacy ratios, as capital was the responsibility of home country regulators. The foreign bank branches would have to conform to Australian liquidity controls. This involved complying with the PAR and placing NCDs at the RBA. In May 1992 a group of 10 foreign banks offered a submission to the RBA which argued that NCDs constituted regulatory duplication, as their home country regulators also imposed reserve requirements (Lewis 1992a). The RBA responded that both the PAR and NCDs provided necessary host country liquidity functions that home country banks were not well placed to provide. In the case of NCDs, the deposits could not be doubling up as they only applied to Australian dollar assets in Australia. Finally, the RBA maintained it was necessary to impose such requirements to ensure competitive neutrality between Australian and foreign banks (Thompson 1992).

One striking absence from the BCBS process was any guidance on the question of how deposit guarantees or insurance schemes should apply to banks outside their home country (Heffernan 2005). Given that depositor protection was the key supervisory task of the RBA, this created a policy challenge. The RBA’s depositor protection function relied on close monitoring and the ability of the central bank to take over a bank that was failing or in distress. In the case of foreign bank branches both were impossible. Despite information sharing with home country supervisors under the Concordat, direct supervision by the RBA was necessarily limited. But more importantly, if the RBA felt it had to assume the affairs of a distressed bank, it could not do so in the case of branched operations: “A branch has no legal status separate and distinct from that of its parent – which is domiciled in another country and operates under separate legal jurisdiction” (Thompson 1992, p. 24).
The solution the RBA came up to this regulatory dilemma was to ring-fence foreign bank branches from the depositor protection provisions of the Banking Act. They did this by creating a new distinction between ‘retail’ and ‘wholesale’ banking. Foreign bank branches were only to operate in the wholesale market. The RBA defined wholesale as accepting large deposits from mostly corporate entities. Deposits could either only be accepted from incorporated entities, non-residents of Australia or (as a practical necessity) the staff of the foreign bank itself. Those depositors that did not meet those criteria had to provide an initial deposit of over $250,000. This threshold was more liberal that the RBA had originally proposed: a single uniform threshold for incorporated and un-incorporated entities of between $250,000 and $500,000. Keating had been convinced to allow limitless deposits from incorporated entities after lobbying from the foreign banks themselves (Lewis 1992b). Foreign bank branches were required to specifically inform depositors that their funds were not covered by the RBA’s depositor protection provisions.

With the Banking Legislation Amendment Bill 1992, which implemented a number of changes recommended by the parliament and which will be discussed in the next chapter, the treasurer maintained a degree of discretionary authority over bank licences. Banks, in the words of the RBA, “will be expected to make a worthwhile contribution to banking services in Australia and not merely add to the number of banks” (Lewis 1992b). Nevertheless, the 1992 branching liberalisation completed the process which had begun in 1985 of introducing foreign competition into the cosy domestic banking industry. Adoption of, and adherence to, BCBS principles was both a necessary response to the demand for regulatory change and, in the case of Basel I, a driver of that change.

8.6 Conclusion
So why was Australia such a quick adopter of Basel I? In late 1989 Graeme Thompson, the RBA’s Financial System Division Chief, argued that Basel I would work in Australia’s competitive favour.
Fulfilling the new capital standards had not been onerous and the ready comparability with other banking systems would demonstrate to foreign investors how well capitalised Australian banks were (Thompson 1990). From the Australian perspective, Basel I would level the playing field in Australia’s favour, demonstrating to the world its high prudential standards. Its adoption was the culmination of a process of regulatory formalisation instigated by the introduction of foreign banks. Implicit in Thompson’s claim is that, in an open financial system, the industry’s reputation for prudence would not be sustained by the discretionary approval of the RBA but required hard, explicit, and public rules about regulatory standards.

Basel I offered a formalisation of the previously subjective risk assessments made by the RBA. Nor was it an onerous system from the perspective of the RBA. A great virtue of Basel I was its simplicity (Leeladhar 2005). Foreign banks had complained about the excessive regulatory burden imposed by domestic requirements like the SRD. Basel I was an internationally accepted standard which could be adopted almost out of the box, reducing the risk of being caught up in a contest over a uniquely Australian regulatory standard. Australia’s adoption of Basel I should be seen in concert with what appears to be a minor adjustment in regulatory practice – the involvement of external auditors into the surveillance process – as both reflected the struggles of a regulatory system that was not used to regulating a large number of firms.

Was Basel I brought on by pressure from the markets to adopt the new framework, as the RBA governor Bernie Fraser argued? “Once standards or requirements of these kinds are agreed in the Committee, and adopted by the central banks in G10 countries, there is considerable pressure on others to follow suit – otherwise their banks risk being perceived as somewhat inferior institutions in competitive situations” (Fraser 1995, p. 26). One of the findings of Chey (2014) is an absence of exogenous market
pressure for adopting Basel I in the countries he studied, South Korea, Taiwan, and Japan. Likewise, Australia was not a reluctant follower of Basel I, pushed by the markets – it was a rapid and enthusiastic adoptee. It sought to abide by the principles of the Concordat when formulating its policy regarding foreign bank supervision. It announced its intention to adopt the BCBS’s risk based capital adequacy standards almost immediately after the draft document was released. It released its formal policy just one month after the Basel committee did, with little variation.

Indeed, the pace of Australia’s adoption came as a surprise to contemporary observers. One banking analyst predicted in January 1988 that “the RBA will probably wait for the larger central authorities to introduce changes, and then bring in its own changes later” (Kaye 1988). RBA adoption was so rapid that it found itself in a position to criticise insider countries - such as Japan and the United States - for dragging their heels on adoption. This is not to suggest that the entirety of Basel I was embraced wholeheartedly by the RBA. One element of the agreement that displeased the RBA was inclusion of subordinated debt as Tier 2 capital. This inclusion made adopting the higher gearing ratio much easier on the Australian banks than it otherwise would have been (Thompson 1990). Hogan and Sharpe (1990b) suggests the RBA felt hemmed into accepting subordinated debt by Basel I and compensated by requiring an original maturity of seven years, rather than the five years specified by the BCBS.

How does Australia’s adoption of Basel fit the models of political economy considered by this thesis? A public interest explanation emphasises that replacing domestic discretion with international formalisation created its own pressures for reform. One consequence of Basel I was that the institutional setting of regulatory change had moved to the international level. International coordination through the BCBS established a norm that capital adequacy requirements are globally, rather than nationally, determined. Basel I was clear and transparent but inflexible (Leeladhar 2005).
The black letter lines of Basel I encouraged regulatory arbitrage, as changing risk management practices, technological and financial innovation, and new forms of debt and obligations altered bank capital. Changing those black letter lines became, after 1988, a matter of global diplomacy as much as domestic reform.

The private interest explanation, following Kane (1990), would depict Australia as seeking to join as quickly as possible an international cartel which the RBA had no role in forming. At the domestic level too, the formalisation of financial regulation in Australia necessitated a reassessment of the organisational and institutional structure of that regulation. Prudential responsibility for banking had been vested with the central bank since the 1945 Banking Act. Ten years after the RBA tied its domestic prudential regulation to global prudential regulation, the Howard government removed that responsibility all together by establishing the Australian Prudential Regulation Authority.

More light is shed on the implementation of Basel I through the framework of subjective political economy. Basel I was an innovation in the Australian context which provided an alternative institution of social control. In the first half of the 1980s the RBA saw the dictatorship costs of risk based capital adequacy rating as insurmountably high, involving too much complexity and surveillance to be practicable. The event that changed the perceived institutional costs was the introduction of foreign banks, who complained about the disproportionate regulatory burden they faced in Australia. The RBA sought an alternative institutional arrangement for prudential management, which was provided at the international level by Basel I. In effect, this was a new point on the IPF, which was seen to minimise the perceived dictatorship and disorder costs of alternative institutions, while satisfying both the RBA, Australian banks, and foreign banks.
9.1 Introduction

The 1996 Financial System Inquiry (the ‘Wallis inquiry’, after its chair, Stan Wallis) was the third major inquiry into the Australian financial system since Federation. The 1937 Royal Commission laid the intellectual foundations of the financial repression that characterised the post-war world, and the 1981 Campbell committee led to the dismantling of that system. Scholars have been less comfortable characterising the significance of the Wallis inquiry in the long term trajectory of financial regulation. Lewis (1997b) argues that, with Wallis, the debate over financial regulation had come full circle. The issue in 1996 was the same as in 1937: how to constrain the power of a few big banks. Where the Royal Commission had recommended government regulation, Wallis recommended market discipline. Merrett (2002) argues that the Wallis inquiry did not represent a sharp break with the past. Rather, it was a continuation of trends in regulation which had evolved over a decade.

This chapter looks at the prudential significance of the regulation of bank mergers in the 1990s. Central to the Wallis inquiry deliberations – and the political debate that surrounding it – was the ‘Six Pillars’ policy, which prevented any of the four major banks and Australia’s two biggest insurance firms from merging with each other. When it was first introduced in 1990 the policy was not introduced for prudential purposes, but in order to maintain competition in the banking sector, which Treasurer Paul Keating believed would be undermined by further amalgamations. The Howard government removed insurance firms from its coverage and the policy became known as the Four Pillars policy. As the Four Pillars policy entrenched itself in the Australian regulatory landscape however, its prudential aspects grew in importance (see, for instance, Harper 2000; Reserve Bank of Australia 1996). The Four Pillars policy is often cited as one of the reasons Australian banks emerged relatively unscathed from the 2008 global financial crisis (Blundell-Wignall 2009; Durie and Gluyas 2009; International Monetary Fund 2012;
Lewis 2013; Quiggin 2011). The Abbott government’s 2014 Financial System Inquiry concluded that banking concentration “exacerbates the risk that a problem at one institution could cause issues for the sector and financial system as a whole” and that the Four Pillars policy ought to be maintained to prevent increased concentration (Financial System Inquiry 2014, p. 34). It is for these reasons that the origin and evolution of the Four Pillars policy is worth consideration in a thesis about prudential regulation.

In this sense, the Four Pillars policy joins bank shareholder limits as another example of a regulatory restriction which was originally driven by populist politics but whose public justification evolved to encompass prudential concerns. In each case, a contingent and temporary political environment left its mark on the regulatory framework that was to govern the sector for decades. The pillars policy established a norm which bound Keating, Howard government Treasurer Peter Costello, and their successors in way that it would have been more costly to approve large bank mergers than had the policy never been announced. A quarter of a century after it was first formulated, the Four Pillars policy is a recognised and established feature of the banking regulatory landscape, despite having no direct statutory support.

The most comprehensive study of the political and economic circumstances surrounding the Wallis inquiry is Bakir (2002, 2003, 2005), who examines the tensions between the “esoteric” content of the Wallis inquiry - technical regulatory questions - and the “exoteric” content - the populist public debate which surrounded the inquiry. Any study of the period is greatly enriched by the extensive interviews with informed sources he conducted, which is particularly the case as we are yet unable to peer inside Cabinet-level decision making for the 1990s. This chapter also leans heavily on published newspaper
reports, as well as submissions and government documents. Access to government archives is limited in this period.

This chapter first explores how the politics of banking changed dramatically in the late 1980s and early 1990s as the Hawke and Keating governments felt the pressure of the RBA’s attempt to break Australia’s high inflation. The anti-bank populism which this brought about manifested itself in the federal government’s anti-merger Six Pillars policy, as well as a number of consumer protection reforms. The chapter then details the politics of mergers at the establishment of the Wallis inquiry, and the inquiry’s approach to this politically sensitive issue. It then examines the evolving justifications for merger and ownership restrictions as these were integrated into prudential control strategies, both in the context of the Four Pillars policy and the Banks (Shareholdings) Act. The chapter concludes by considering the Howard government’s response to the Wallis inquiry and addressing the significance of these debates through the theoretical models of this thesis.

9.2 Anti-bank populism in the 1990s
Some commentators have drawn a comparison between the recession of 1990-91 and the Great Depression (see, for instance, Tingle 1994). The comparison is instructive. In both cases the banking system bore the brunt of popular resentment about the economic downturn. In the Great Depression such resentments were manifest through the labour movement’s Money Power doctrine and the heterodox monetary theories of the period. In the 1990s recession the context was quite different – it was a Labor government which had enabled, or at least was seen to have enabled, the ‘cowboy capitalism’ in which the crisis began.

By the early 1990s structural changes to the banking industry had lost the political salience they had a decade earlier. The parliamentary debate over the 1989 Banking Legislation Amendment Act, which
introduced NCDs and eliminated the regulatory distinction between trading and savings banks, was indicative of the changing political climate. The substance of the bill was supported by the conservative Coalition opposition. The opposition’s line of attack rather focused on the high interest rates prevalent at the time. In June 1989 the standard variable home loan rate reached 17 per cent. The Coalition argued that the high rates were the consequence of the Hawke government’s monetary policy. On the Labor side, parliamentarians rose to direct the debate away from structural reform and towards an attack on the relationship between banks and consumers. “Does the ordinary customer really understand the benefits about each package?,,” asked one typical speech in the parliamentary debate, “Have the banks really gone out to explain what they are offering?” (CPD, House of Representatives, 16 August 1989, p. 93). The bill passed parliament smoothly, but the changing political emphasis was obvious.

Parliament showed a similar lack of interest in the introduction of foreign bank branches in 1992. The announcement of foreign bank branches was relegated to the supporting material in Paul Keating’s One Nation statement, and not mentioned in his highly publicised parliamentary speech. As Earl (1992) wrote, One Nation lacked the “familiar soaring rhetoric about financial deregulation”, and attention given to the banking changes was “relatively scant”. In part this was because reform attention had shifted onto other sectors, such as aviation and tourism. Yet for the most part the reduced attention paid to structural reform was a consequence of the changing politics of banking.

The new political environment was in large part due to the RBA’s aggressive monetary policy. In 1990, the RBA took advantage of the record high interest rates to stamp out Australia’s high levels of inflation once and for all. Bell (2004, p. 69) describes this as an example of elite-led policy making: “Australians would get low inflation whether they wanted it or not”. This elite policy stance was accompanied by a
political critique by the government of the banks. When the RBA started easing the cash rate in the second half of 1990, Keating accused the banks of undermining monetary policy and driving up interest rates through cross-subsidisation and fees. “The banks,” the Treasurer claimed, “are in effect running an additional monetary policy of their own” (Tingle 1994, p. 257). While the opposition had been sheeting blame for high interest rates and inflation onto the government, Keating was turning political attention to the pricing strategies of the banks. Commentators recognised at the time that ‘bank bashing’ from 1989 onwards was an attempt at political misdirection. Stutchbury (1989) wrote that the Hawke government was looking for “a scapegoat to take the rap for the macro-economic damage caused by this debt binge”. Gittins (1989) argued “the more the electorate blames the [interest rate] increase on the greediness of the banks, the happier Mr Hawke and Mr Keating will be.”

Further popular, media, and political dissatisfaction was directed towards bank profit margins. The ALP federal secretary Bob Hogg complained in late 1990 that the close relationship between the Labor party with the union movement meant that the government could tame the unions, but had no similar influence over the banks (Horin 1990). Anticipating a possible regulatory backlash, the banks established a banking industry ombudsman to deal with complaints about banking practices (Armitage 1990). This manoeuvre had little impact. In August 1990 Keating announced a Treasury inquiry into bank lending policies and prices, arguing that while the government had “done more for the banking sector than any government ever”, the banks had not lived up to the implied “two-way street”. Keating went on: “The banks have to understand that retribution is coming if they keep this policy up” (Burrell et al. 1990). It took several weeks for a rate cut in August 1990 to flow through to home loan rate reductions, and the banks were warning that an October 1990 easing might not manifest itself in lower mortgage rates for months (Ellis 1990). Keating threatened to penalise the banks if they did not follow the government’s monetary stance by implying that the SRD phase out could be delayed, or as one informed source told a
reporter, the RBA could impose “lots of little penalties throughout the system” if the banks were not cooperative (Burrell, Lloyd and Brass 1990).

The conclusion of Keating’s Treasury inquiry into banking practices was virtually foreordained (Lloyd 1990b). Treasury believed the banks were charging higher than necessary rates for business loans in order to compensate for the corporate loans that had gone bad during the recession. These ‘excess’ charges were imposed opaquely through add on fees. Treasury found that the banks were set to extract $1 billion from their customers by keeping interest rates higher than necessary (Cleary et al. 1990). Keating used the Treasury inquiry as a cue to announce a public inquiry into bank competitiveness, profitability, and consumer products.

This next inquiry, which ultimately resulted in the A Pocket Full of Change report (Standing Committee on Finance and Public Administration 1991), was decidedly more modest in scope than the Campbell committee or even the Martin Group. Rather than establishing an independent inquiry, Keating handed it over to the House of Representatives Standing Committee on Finance and Public Administration. This institutional choice was “designed to create the “maximum possible heat, noise and headline hunting over the next year or so” but would result in “the least authoritative outcome,” as one commentator wrote (Robinson 1990). There was little likelihood of the backbenchers’ committee offering up any substantive reform. It was an exercise in catharsis as much as policy analysis. On top of 121 formal submissions there were over 800 submissions (and “complaints”) from individuals “about bank interest rates, fees and charges; problems with access to too little or too much credit; and allegations of malpractice, fraud and corruption in the banking industry” (Standing Committee on Finance and Public Administration 1991, pp. 5-6).
This populist focus was reflected in the standing committee’s conclusions. While its report was generally supportive of regulatory reforms since 1984, it concluded that “deregulation has not delivered some of the benefits envisaged”, particularly as customers still faced asymmetric information about bank products and prices (Standing Committee on Finance and Public Administration 1991, p. 457). Many of its recommendations hinted at a return to regulatory control, but were ambiguously phrased. For instance, it recommended banks pay a “reasonable rate of interest on all deposit accounts” - although whether this was a proposal for interest rate regulation or just a suggestion for bank management was unclear. *A Pocket Full of Change* called for a Prices Surveillance Authority inquiry into credit card interest rates, and proposed a contractual “code of banking practice”, which would be developed in consultation with the Trade Practices Commission and enforced by bank customers. In effect, the standing committee was proposing a move away from market discipline on banking practice and interest rate setting towards a more interventionist approach. Its governance recommendations were more prosaic. *The Pocket Full of Change* paid little attention to the mainstays of banking regulation: monetary and prudential controls. The standing committee recommended greater coordination between state and federal prudential authorities and that a new Deputy Governor role be established at the RBA dedicated to banking supervision. A follow up report, *Checking the Change* (Standing Committee on Banking Finance and Public Administration 1992), criticised the failure to implement many of its predecessor’s recommendations but stopped short of recommending new regulatory controls.

### 9.3 The Six Pillars policy and the politics of bank mergers

The Hawke government’s position on bank mergers was inextricably tied up with the fact that it owned one of the four major players, the Commonwealth Bank of Australia (CBA), the trading bank which had resulted from the Commonwealth Bank / RBA split in 1959. In early 1988, Keating expressed a desire for the creation of “superbanks” which would compete on the world stage, and publicly encouraged the
possibility of a merger between the CBA and the National Australia Bank or the ANZ (Cleary 1988). In the short term, this would have constituted a nationalisation of the National Australia Bank. Keating believed that a merger would also “generate a more commercial culture” in the CBA in the lead up to its ultimate privatisation (Westfield 1988). More broadly, a consolidated banking sector would also make Australian banks more competitive on the global stage (Lloyd 1988).

Yet Keating’s enthusiasm for bank mergers was limited to expanding the CBA. When the ANZ and National Australia Bank started making early moves towards a merger in 1989, Keating was quick to scuttle the idea, telling parliament that such a move would present “very grave difficulties” for the competitiveness of the Australian banking system (CPD, House of Representatives, 3 October 1989, p. 1254). A number of commentators speculated this could be connected to the fact that the CBA would have lost market share – and therefore potential value for privatisation – to the newly merged entity (Kohler 1989; Walsh 1989). Six months later, Keating rejected another merger; this time between ANZ and the insurance agency National Mutual.

The principle he established in rejecting that merger was that the government would reject any merger between the four biggest banks (Westpac, the National Australia Bank, ANZ and the CBA) or the two biggest life insurance agencies (AMP and National Mutual), a principle which came to be known as the ‘Six Pillars’ policy. The statutory basis for the Six Pillars policy was the discretionary powers within the Banking Act and the Insurance Acquisitions and Takeovers Act for approval of any amalgamation (Bakir 2002). From Keating’s perspective, the Six Pillars policy was needed to ensure the adequate competition in banking and insurance that he believed was under threat. The government also made it clear it was not interested in allowing a foreign bank to take over any of the six major banks. The Six Pillars policy was seen by many at the time as a major event in the history of Australian political economy. It was
described as a “neutron bomb” (Dunstan 1990) and characterised as the end of the Labor government’s interest in deregulation and free market reform (Burton 1990).

9.4 The Wallis inquiry
The early 1990s saw a political division between the Coalition and the Labor Party as to the need for banking reform. Where Labor sought to focus on consumer issues through the *Pocket Full of Change* inquiry, the Coalition started building momentum for a further reform into the governance of banking regulation. The opposition leader John Hewson took a proposal for a new inquiry into prudential regulation to the 1993 election. The inquiry would have been focused on the “completely haphazard” regulatory structure between state and federal regulated financial institutions (Lewis and Boyd 1993). In Hewson’s view the RBA had failed to transition between the relationship-based regulation that existed before the entry of foreign banks and the formal rule-based regulation which was needed in an era of many competing financial institutions. One analyst noted that

> what we have observed is the Reserve Bank having to cope with an environment where you can't just give a nod and a wink ... I think the whole thing is a question of style with the Reserve Bank becoming more direct and that's the way they have to go. The more players you have in a game the more disciplined you need to be if you are refereeing it. (Sexton 1993)

However, the opposition leader did not propose an increase in regulatory control. Rather, Hewson proposed that the supervisory authority could be empowered to produce an annual assessment of the soundness of financial institutions and risk-rate them separately. Consumers would then be able to choose their institution depending on the level of risk they were willing to bear. This was not to be considered re-regulation of the financial sector; rather it would be a “prudential supervisory structure that monitors and exposes without regulating” in Hewson’s words (Lewis and Boyd 1993). While Hewson’s 1993 election loss meant that his proposal did not go any further, the bare bones sketched
during the campaign emphasised the role of market discipline in prudential control assisted by
government information provision to resolve information asymmetries. In this light Hewson’s proposed
institutional setting is an example of what Rochet (2008, p. 294) describes as “indirect market discipline”
(see also Byford and Davidson 2013). It is the only proposal to move prudential policy towards market
discipline offered by a major Australian party in the period studied by this thesis.

While Hewson’s proposal for prudential reform was a dead end, his more general proposal for a new
inquiry into the financial sector was relaunched by the Coalition in the 1996 election. In November 1995
the shadow treasurer Peter Costello announced that if elected there would be a fresh inquiry into the
Australian financial system: “the daughter of Campbell”. This was to become the Wallis inquiry. The
primary focus of the Wallis inquiry was to be governance structure of financial regulation rather than
the regulation itself. Treasury had been pushing for an inquiry into financial regulation since at least
1994, with limited success on the Labor side. In June 1994 the Labor treasurer Ralph Willis had hinted
that some sort of reform to regulatory structures would be needed if financial product and institutional
convergence continued (Ellis 1995). One “senior respondent” told Bakir (2002, p. 91) that

The Treasury had actually pushed the opposition and the government. Before the time of the
election both [Willis and Costello] agreed to have an inquiry. Whenever that happens you see hands
of bureaucrats behind the curtain.

9.4.1 Establishing the Wallis inquiry

The Howard government learned much from the experience of the Campbell committee. When it was
elected to government on 2 March 1996, it was quickly made clear that the Wallis inquiry was to be fast-
tracked. Not only did the new government propose an extremely short timetable (beginning in the
middle of 1996 and reporting by March 1997), but it also set a provisional deadline for legislative change
for 1997. Costello told the banks to start work on their submissions before the inquiry had even been formally announced: “The message I want to give (the financial sector) now is start preparing your act. You've got three months, get going” (Field 1996). To facilitate the haste, hearings were held in private (Daley 1996), and the government even considered restricting consideration of submissions to invited submissions only (Gray 1996a). While in the event Wallis had an open submissions process, this latter consideration was intended to avoid the inquiry being inundated with the complaints about bank products and behaviour that had met the *Pocket Full of Change* Inquiry half a decade earlier. One consequence of this haste was that the inquiry was unusually reliant on material drawn from the submissions rather than its own research (Valentine 1997).

Likewise the scope of the Wallis inquiry was to be kept limited. It was to have none of the sprawling breadth of the Campbell committee. The Wallis inquiry was make “recommendations on the regulatory arrangements and other matters affecting the operation of the financial system”. Nor was there any direction given as to the philosophical approach the inquiry was to take. The Campbell committee had been instructed to have a mind to the “free enterprise objectives and broad goals for national economic prosperity”. The 1984 Martin Group had been tasked to have in mind the “Government’s social and economic objectives”. No such ideological superstructure was directly imposed on the Wallis inquiry: rather it was to seek an “efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness”.

The chair of the Wallis inquiry was Stan Wallis, managing director of the packaging firm Amcor Ltd. He was joined by two academic economists – Jeffrey Carmichael and Ian Harper, alongside two representatives of the finance industry – Bill Beerworth, a merchant banker and solicitor, and Linda Nicholls, the former executive director of County NatWest Australia Investment Management. As
Prasser (2003) points out only Carmichael could be considered as a representative of the public sector, as he had been the chairman of the Australian Financial Institutions Commission. However, that balance was more than compensated for by the inquiry’s secretariat, which was dominated by Treasury officials and established in the Treasury building in Canberra (Bakir 2002). Ellis and Gray (1996) wrote that “many believe the secretariat will be far more influential than was the case in other recent inquiries into banking issues”. Given the short time frame offered to the inquiry this was inevitable.

9.4.2 Bank consolidation in the mid-1990s

The mid-1990s was a sensitive time to hold an inquiry into banking. Across the world, the banking industry was undergoing a major restructuring that had been brought on by parallel liberalisations of financial markets in many of Australia’s trading partners. The mergers that exercised Australian policymakers were part of a global phenomenon. The BIS pointed out that globally “forces are obliging many banks to consolidate ... whether the competition stems from within the industry or outside it, from other financial intermediaries, open capital markets or even non-financial companies themselves” (Bank of International Settlements 1992, p. 204) An RBA conference in late 1996 heard that “the likely trend in many countries is for a reduction in the number of independent banking units and a concentration into a smaller number of larger units” (Llewellyn 1996, pp. 164-5).

In Australia, 1996 was the beginning of a wave of bank consolidation. As the inquiry was deliberating, there were takeover bids and takeover rumours surrounding BankSA, BankWest, Challenge Bank, Metway Bank, St George Bank, the Bank of Melbourne, and Advance Bank. These were all permissible under the Six Pillars policy. However, the suggestion that the National Australia Bank could swallow either Westpac or ANZ was not (Flint 1996a). It was widely speculated that if one of the results of Wallis
was the end of Six Pillars, there was a very good chance that there would be a ‘mega-merger’ before the end of financial year 1996-97.

One particular merger set the political tone for discussions about bank consolidation. In October 1996 St. George Bank announced it was going to buy Advance Bank. It was to be one of the largest takeovers in Australian banking history. The two New South Wales regional banks were both originally permanent building societies. Advance, formerly the NSW Permanent Building and Investment Society, gained its bank licence in 1985, and the St. George and Cronulla Building Society became a bank in 1992. The merger between the two was “obvious”, wrote Bartholomeusz (1996) and their union would create Australia’s fifth largest bank. The deal had been on the cards for some time but the Wallis inquiry gave it a sense of urgency – there was the possibility that one of the major banks would be empowered by Wallis recommendations to snap up Advance (Yiannakis 1996). Increasing the political significance of this possible merger was the fact that St George and Advance had 167 branches that substantially overlapped, and it was predicted that there would be at least 1000 jobs lost from the merger (Allard 1996). This suggested that any bank consolidation in the wake of Wallis would also be accompanied by job losses. One article in the *Australian Financial Review* editorialised that the merger “gave Australia a tiny taste of what life could be like in the post-Wallis inquiry era. Fewer banks, fewer branches and far fewer people working in them” (Ries 1996a). As one Liberal politician reflected a few years later,

At that time, some people were concerned about the consequences of mergers as it worked out in practice with the closure of branches, reduction of physical working services, replacement by electronic services and so on. A broader cross section of the public became concerned about banking issues. Earlier on when we were talking about the mergers it was a bit 'esoteric', theoretical. Now it is down the ground. Some of the consequences become apparent. I think that had broadened the debate publicly. (Bakir 2002, p. 183)
The domestic merger between Advance and St. George sparked a great deal of speculation about further mergers that might be made possible by Wallis recommendations. Possibilities raised in the press included a National Australia Bank takeover of Westpac, and the possibility that ANZ might be acquired by the Hongkong and Shanghai Banking Corporation (HSBC) (Kirby 1996).

9.4.3 Mergers and the Wallis inquiry

In this fevered and highly speculative environment, what did the Howard government hope for from the Wallis inquiry on the question of mergers? Individual bank mergers were outside the terms of reference for the inquiry, as Stan Wallis told an audience in September 1996, but the inquiry would address questions of structure and ownership as part of its broader mandate (Luff 1996). Bakir (2002) argues that Costello intended the Wallis inquiry to legitimise a pro-merger position and the abolition of the Six Pillars policy. But the evidence for this is not as strong as Bakir suggests. The claim that Costello was “very pro getting rid of ‘four pillars’” comes from a Labor opponent (Bakir 2002, p. 167). More compellingly, Bakir points out that at least three of the members of the Wallis committee had previously stated their support for mergers – Ian Harper, Bill Beerworth, and Stan Wallis himself. However, the evidence Bakir cites for the three of them all post-dates their appointment to the inquiry. It is true that there may have been good reason for Costello to believe the three supported mergers before their appointment. Harper was a long-time supporter of deregulation and one-time director of Westpac, and Beerworth specialised in takeovers. Yet these are hardly the smoking guns that, for instance, Vic Martin’s published and explicit opposition to the introduction of foreign banks was for determining pre-existing policy preferences of inquiry participants.

Nor did Costello take a clearly pro-merger position before the announcement of the Wallis inquiry. During the 1993 campaign Hewson and the shadow treasurer Peter Reith had both suggested that they
would be open to allowing mergers between at least two of the four major banks, as well as permitting foreign bank takeovers (Walker 1993a, 1993b). But when Westpac launched a takeover of Challenge Bank in 1995, the only statement that Costello’s office would release was that “We think it's important to foster competition in the financial sector and would only allow a megamerger if there was some overwhelming public interest”. As the *Sydney Morning Herald* noted, the office “would provide no further guidance on what circumstances Mr Costello might see as representing ‘overwhelming public interest’” (Korporaal 1995). The contrast with the Hewson opposition's public support for lifting restrictions on bank mergers is stark.

The attitude of the Commonwealth treasurer to takeovers was not the only barrier to a bank merger free-for-all. In 1992 the Trade Practices Act was changed to prohibit mergers that would result in a “substantial lessening of competition” (*Trade Practices Legislation Amendment Act* 1992). The previous test was a ‘dominance’ test, where mergers would be only prohibited if they created or strengthened an entity with dominance in their market. The 1992 change therefore significantly lowered the threshold by which the Australian Trade Practices Commission (ATPC) and then the Australian Competition and Consumer Commission (ACCC) could bar mergers. In practice this meant that even if the treasurer approved a bank merger it could still be rejected by competition regulator. This was raised as a problem for John Hewson during the 1993 election when he first suggested that he was sympathetic to bank mergers (Ries 1993).

The ATPC/ACCC’s control over bank mergers and the policy that governed that control was highly opaque and uncertain. In 1995 the ATPC chief Allan Fels approved the acquisition of Challenge Bank by Westpac but suggested that he was unlikely to approve an application by the big four banks to acquire a dominant regional bank in states with only one dominant regional bank (Flint 1996b). From the vantage
point of banks and policymakers in 1996, not only did this make it unlikely that the major banks could be able to acquire some of the larger regional banks, it also made it very unlikely the ACCC would approve an even larger merger between the big four banks (Korporaal 1996). As the Wallis inquiry progressed, Fels objected that he had not instituted a “magic rule” that would automatically prevent any attempt to merge the big four banks, claiming in July 1996 that “there are occasions when mergers can be good for competition by reducing costs and rendering a business more efficient” (Gray 1996b). The Trade Practices Act allowed the ACCC to waive the substantial lessening of competition test if it was shown that “proposed acquisition would result, or be likely to result, in such a benefit to the public that the acquisition should be allowed to take place.” (Trade Practices Act s. 90(9)). There was even some suggestion that the ACCC might wave through a merger between ANZ and Westpac by adopting a higher permissible market ownership test (Ries 1996b).

While the ACCC’s approach to mergers was ambiguous and its reasoning opaque, it was a beacon of transparency compared to the provisions in the Banking Act and Banks (Shareholdings) Act that gave the treasurer discretionary powers of approval for mergers. The Banking Act provided no guidance as to the principles under which a merger or ownership bid would be granted. In its submission to the Wallis inquiry, Treasury noted that the treasurer usually considered “any prudential considerations, the potential efficiency gains resulting from any rationalisation, and any potential losses resulting from reduced competition in the financial sector” but these would be considered “on a case by case basis” (Department of the Treasury 1996, p. 146). Westpac argued this approach “lacks transparency and creates uncertainty, which is inconsistent with an efficient financial system” (Westpac Banking Corporation 1996, p. 137).
The Wallis inquiry was presented with a virtual consensus around merger liberalisation. All the major banks, as well as the RBA and the ACCC, supported the removal of the Six Pillars policy. For the most part, these submissions supported a model that had been proposed by the ACCC. The Banking Act should be amended to provide specific guidance to the treasurer that merger or ownership considerations should not be based on competition concerns. Mergers between banks and insurance companies “should only be subject to the Trade Practices Act and prudential requirements” (Australian Competition and Consumer Commission 1996, p. 38). Implicitly, this would end of the Six Pillars policy, which had been justified to protect competition, rather than on any prudential considerations.

Furthermore, it recommended that restrictions on foreign shareholding in the Foreign Acquisitions and Takeovers Act 1975 and Banks (Shareholdings) Act 1972 be removed.

Nevertheless, this apparent consensus concealed some differences. The major banks, unsurprisingly, supported merger liberalisation. The ACCC position was supported by the Commonwealth Bank (1996, p. 11) and Westpac Banking Corporation (1996, p. 138). However the ANZ (1996, p. 62) was critical of the ACCC’s strict definition of the relevant size of a market, which was based on state borders and did not take into consideration competition from NBFIs offering bank-like services. The National Australia Bank (1996, pp. A4-2) offered a detailed critique of the ACCC’s merger principles, arguing that the ACCC had an excessively static view of sectoral competitiveness: “competition is a process which is both rich in its terms and needs to be evaluated in the context of a long run time frame” (National Australia Bank 1996, pp. A4-14). Views within government authorities were more mixed. The RBA supported the elimination of the Six Pillars policy and concurred that the ACCC’s approach to mergers was “overly restrictive” in its focus on state-level markets rather than national ones (Reserve Bank of Australia 1996, p. 74). The Treasury conspicuously reserved its views on the Six Pillars policy, providing neither support
for the Keating-era policy nor a critique of merger restrictions (Bakir 2002; Department of the Treasury 1996).

The Wallis inquiry final report was presented to the government on 18 March 1997, and released to the public on 9 April 1997. It constituted nearly 800 pages and made 115 recommendations. On mergers, the broad principle applied by the Wallis inquiry followed the recommendations of the 1993 Hilmer Committee on National Competition Policy that general rules should govern all sectors “with exemptions for any particular conduct only permitted when a clear public benefit has been demonstrated through an appropriate and transparent process” (cited in Financial System Inquiry 1997, p. 419). In practice this meant that special prudential regulation could be applied to banks, but on the matter of competition, banks should be governed by the same rules that governed other sectors. It made this case for regulatory neutrality partly on the grounds of the increasing convergence between banks and NBFIs:

non-traditional suppliers, such as retailers, telecommunications companies and manufacturers, are presently entering the financial system. This convergence would make the practicality of administering a separate competition regime for the financial system extremely difficult. (Financial System Inquiry 1997, p. 419)

The Wallis inquiry recommended that banking and insurance legislation be amended to clarify that the sole assessment of the competition effects of mergers be vested with the ACCC and the Trade Practices Act. The inquiry considered the question of the Six Pillars policy separately and explicitly recommended its removal. Furthermore, the Wallis inquiry recommended that the legislative framework was also to be amended to clarify that prudential considerations surrounding mergers should be the responsibility of the prudential regulator, rather than the treasurer.
The Wallis inquiry did not recommend a laissez faire approach to mergers and ownership. Existing economy-wide restrictions on foreign ownership were to continue to be imposed on banking mergers and acquisitions. Keeping those restrictions was consistent with other recommendations. However, on the prospect of foreign takeovers of Australian firms, the Wallis inquiry evinced less of the scepticism that characterised its discussion of bank merger constraints. While agreeing that “there would be no economic disadvantage in some increase in the percentage of foreign ownership of the Australian financial system”, the Wallis inquiry also editorialised that

the Inquiry does not consider that a large scale transfer of ownership of the Australian financial system to foreign hands would be in the national interest. Such an eventuality could restrict the options for the future development of the financial system and Australia’s place in the regional and global economy. The general scheme of regulation of foreign investment is sufficient to meet this objective. (Financial System Inquiry 1997, p. 475)

In the view of Bakir (2002, p. 183), the purpose of reducing the treasurer’s control over mergers was to “to depoliticise the issue of bank mergers”. But the Wallis inquiry’s enthusiasm for depoliticisation went only so far. Despite agreeing that foreign investment control decisions are made according to the “social and political climate of the time” (Financial System Inquiry 1997, p. 475), the Wallis inquiry nevertheless gave the treasurer intellectual ammunition and mandate to resist a foreign bank takeover.

9.4.4 Ownership limits

Nor did the Wallis inquiry support the deregulation of bank ownership restrictions. It argued that the Banks (Shareholdings) Act 1972 was a prudential measure, and that as a consequence the ownership limits could be maintained while adhering to competitive neutrality.
The primary policy rationale for this legislation is prudential: namely, that such restrictions are needed to ensure a wide spread of ownership in order to minimise the likelihood of the stability of a bank being prejudiced by the influence or varying fortunes of a particular shareholder. (Financial System Inquiry 1997, p. 422)

This stance is perhaps not surprising, given the heavy Treasury dominance of the Wallis inquiry: that argument was consistent with the advice Treasury had offered the Hawke government against the arguments of Department of Prime Minister and Cabinet. It was also reflected in the Treasury submission to the Wallis inquiry (Department of the Treasury 1996, p. 96). There was no submission from the Department of Prime Minister and Cabinet, which had maintained in 1984 that ownership limits provided no prudential benefit and should be abolished.

For its part, the RBA supported the retention of the shareholdings constraint in 1996. The RBA argued that dispersion of ownership contributed towards stability, and in circumstances where the limitation had potential anti-competitive effects, the exemptions within the act were sufficient to prevent such effects manifesting themselves (Reserve Bank of Australia 1996, p. 49). Indeed, the RBA had turned its mind to diversification of ownership and control shortly after the introduction of foreign banks. A prudential statement (B1) released in December 1986 focused on limiting ownership and control from single shareholders. In the RBA’s view, concentrated ownership would undermine due regard to the interests of depositors. Thus the RBA placed restrictions on the ratio of ownership to board representation. This was to resolve the apparent discovery that ownership and control were not synonymous. One of the effects of this prudential governance policy was to constrain potential mergers. In its Wallis inquiry submission, the RBA noted that such limits on governance “restrict opportunities for takeover and impede market entry, which may, in turn, inhibit moves to promote competitive
efficiency” (Reserve Bank of Australia 1996, p. 49). Nevertheless, it had concluded that shareholdings restrictions were a necessary prudential tool.

Was the Wallis inquiry right to see ownership and control limits as a central part of the government’s prudential armoury? The policy community’s view represented by the Wallis inquiry was that concentrated ownership might encourage a small number of shareholders to direct the firm to act in the interests of shareholders rather than depositors. The implicit claim here is that market discipline would continue to be absent under a regime of banking regulation. Yet in 1996 the evidence for this proposition was far from definitive. There were relatively few direct studies on this issue, despite the obvious regulatory interest, and most of those were from the United States. Hogan and Sharpe (1989, p. 21) surveying the literature, concluded that “both the theory and empirical evidence relating ownership concentration to the prudential objective of system stability are inconclusive”. Two Australian studies published just before the Wallis Inquiry cast doubt on the prudential benefits of shareholder limits. Davis (1995) maintained that the shareholdings limitation reduced the disciplinary effect of market control on management by undermining the ability of disaffected parties to affect takeovers or board shakeups in pursuit of management change. Sharpe (1995) made a similar argument even more pointedly: limitations on ownership concentration allowed management to work more in its own interest than would be possible without those limitations. In this light, it is possible that the long staying power of the Banks (Shareholdings) Act illustrates the continued susceptibility of banking to the regulatory capture described first by Stigler (1971).

9.5 The Howard government responds to Wallis
Peter Costello had stipulated that for the duration of the inquiry there would be no approval for any mergers between the four major banks. Just before the release of the Wallis inquiry’s final report merger rumours were at a near fever pitch. Westpac launched a takeover bid for the Bank of
Melbourne, prompting Costello to accuse Westpac of jumping the gun on the report (Frith 1997). The treasurer’s response was somewhat tendentious, considering that the merger would not have breached the Six Pillars policy, nor was it affected by the Wallis recommendations which had already been delivered to the government and were to be released to the public a few days later. It is nevertheless a good example of what Bakir (2003, 2005) considers to be the “exoteric” politics of bank mergers around the Wallis inquiry: political concerns driven by populist worries of jobs and competition, rather than technical considerations about banking regulation.

Likewise, the pressure created by possible mergers between the major Australian banks meant that with the release of the Wallis report Costello had to make clear the government’s policy on mergers before it provided a detailed response to the report’s recommendations. The full Wallis inquiry recommendations were not considered by the Cabinet until August 1997 (Reith 2015). But when its report was publicly released in April 1997, Costello released a statement announcing that while the Six Pillars policy was to be abolished in accordance with the Wallis recommendations, “mergers among the four major banks will not be permitted at this time” (Costello 1997). In effect this merely removed insurance firms from the Six Pillars policy; the policy was subsequently known as ’Four Pillars’ and the blanket ban on mergers between Westpac, the National Australia Bank, ANZ and the CBA remained. The stay on mergers was presented as a temporary measure:

> This will be reviewed when the Government is satisfied that competition from new and established participants in the financial industry, particularly in respect of small business lending, has increased sufficiently to allow such mergers to be considered. (Costello 1997)

The populist tinge to this announcement – particularly the reference to “small business lending” – is notable. The Howard government was seeking to exploit the quid pro quo relationship on banking
regulation that had been sought in the last few years of the Hawke-Keating government. Howard clarified these comments in a subsequent interview, arguing that competition in the mortgage market had driven down interest rates but had not done so yet for small business loans:

The thing that got housing interest rates tumbling for people was Aussie Home Loans. They were new players and they challenged the monopoly (of the banks) and they drove interest rates down.

The same thing has got to happen with small business. (Megalogenis 1997)

Similarly, the government rejected the Wallis inquiry recommendation that the treasurer’s veto over mergers be strictly limited. Costello was explicit that he would continue to consider competition issues as well as prudential ones, that he would take advice from “but [would] not be limited by” the determinations of the prudential and competition regulators. The discretionary power would remain vested in the treasurer’s office.

Even when the government’s initial response did offer some deregulatory initiatives in the area of bank mergers and ownership, this discretionary power was maintained. While the element of the Six Pillars policy that provided a blanket ban on foreign takeovers of the major banks was to be eliminated, and decisions regarding foreign investment were to be governed by the economy-wide foreign takeovers rules, in practice this change meant that foreign takeover decisions were ultimately vested in the office of the treasurer. This was compounded by Costello’s endorsement of the Wallis argument that “any large scale transfer of Australian ownership of the financial system to foreign hands would be contrary to the national interest” (Costello 1997).

Four Pillars was not yet set in concrete. In 1999 a new campaign against the Four Pillars policy was launched by the major banks (Gibson 1999). As part of the second tranche of Wallis legislation in 1999 (which focused primarily on bringing non-bank financial intermediaries into the supervisory remit of the
new prudential regulator, the Australian Prudential Regulation Authority), the government introduced an amendment to the banking legislation which would have seen it possible for the treasurer to waive their requirement to consent for mergers and ownership transfers between financial institutions of any size. If that consent was waived, the decision as to whether a merger would be approved or not would rest with the Australian Prudential Regulation Authority (APRA). The Labor party argued this provision meant it would be “technically possible for the bills to operate to erode the four pillars policy” (Senate Standing Committee on Economics 1999). Consistent with his claim that the Howard government was eager to facilitate bank mergers, Bakir (2003, pp. 191-2) agrees, arguing that “this was a deliberate effort of the government to make merger policy discussions ‘esoteric’. As a result, merger decisions could be left to civil servants and could be structured to favour the interests of these large financial firms over other interests.” The ability to waive consent meant that the treasurer had a choice to allow merger decisions to be made on technocratic, rather than populist-political grounds - delegating responsibility to an apolitical independent regulatory agency.

The significance of these changes has been overstated. Under the 1999 proposed amendments, the treasurer would still have to choose to waive their right to consent. In effect, the Four Pillars policy remained a discretionary position held by the treasurer of the day, rather than reflecting black letter legislative control. A large bank merger would be hard to slip under the public’s radar. In fact the new provisions would have been a more effective tool for mergers between smaller institutions, allowing the government to vary merger justifications depending on whether they wanted those decisions to look as if they were made on technocratic or populist grounds. If the Four Pillars policy was driven by popular concerns that the public would blame the government for a reduction in competition in banking, there was nothing in the 1999 package which would change that political equation. Nevertheless, the Labor Party insisted on amendments to the 1999 package that emphasised the need to obtain consent from
the treasurer for mergers and acquisitions, which were accepted and the Four Pillars policy was granted a further degree of permanence.

9.6 Conclusion
Paul Kelly (2009, p. 275) draws some broad conclusions from the Howard government’s decision to reject the Wallis inquiry’s recommendation on mergers, in that they reveal the “policy character” of the Howard government:

On financial regulation they were liberal traditionalists – they believed in a freer financial system with more play to market forces but recognised that a sound regulatory regime was essential. Unlike many governments, they took such responsibility seriously and were ably assisted by the Reserve Bank and APRA.

Yet there is little reason to believe that the Four Pillars policy was maintained by a fundamental belief in a “sound regulatory regime”. As evidenced by the submissions to the Wallis inquiry, there was a broad consensus between both the public service and the banks that Keating’s Six Pillars policy ought to be eliminated and the only consideration that would prevent a merger be made on prudential grounds. This consensus provides a plausible public interest approach to merger regulation as of the mid-1990s. Instead, populist concerns about the effect of bank mergers on jobs, and popular notions of banking competitiveness swamped technocratic concerns about banking regulation and efficiency. Populist concerns about banking were a constant feature of the politics of banking throughout the 1990s. During the recession of the early 1990s Paul Keating made an explicit decision to direct the popular anger with the government’s monetary stance towards the private banks. In 1992 the A Pocket Full of Change inquiry was swamped by complaints about customer relations, interest rates and consumer protection. Indeed, it was widely acknowledged that the Wallis inquiry, by avoiding a focus on consumer issues, was bucking the political zeitgeist. To the extent that populism determined the Howard government’s final
decision on banking mergers, it was a populism of its time: a reflection of the era’s concern that the benefits of deregulation had not flowed through to consumers.

That banking populism of the 1990s shaped the direction and purpose of the Wallis inquiry in subtle and important ways. The Howard government specifically intended the inquiry to skirt over the consumer issues that had characterised parliamentary inquiries into banking under the later Hawke and Keating governments. Peter Costello had a very specific goal for the Wallis inquiry in mind: it was to facilitate the organisational change by recommending the separation of prudential regulatory authority from the RBA into a separate prudential regulator. However, the upshot of political pressures created by the Wallis inquiry process was that the Howard government reiterated, rather than reformed the two major regulatory constructs: the pillars policy and the Australian deposit guarantee (which I will return to in Chapter 11). The electoral cycle might have also been a concern as well. Had Costello eased merger rules in 1997, the National Australia Bank would have probably moved to takeover Westpac or the CBA, and precipitated a parallel merger between the two remaining giants. “The big program of branch closures would be well under way around election time” (Westfield 1997).

Thus we can draw a private interest explanation from the Howard government’s support of the Six/Four Pillars policy in which the government sought to avoid the short term electoral consequences of the effects of bank mergers on employment. Benson (1983) shows how the United States Congress responded to a similar demand from small unit banks for controls on the expansion of multi-unit bank holding companies which they believed were trying to monopolise the sector. In Australia, smaller regional banks, such as the Bank of Melbourne and Advance Bank, which would be disadvantaged if large mergers drove competitive efficiencies in the major banks, were supportive of the Six/Four Pillars policy (Bakir 2003). As Clark (1996) noted, the growth of non-bank mortgage providers was placing
further pressure on smaller banks, whose balance sheets were disproportionately concentrated in mortgages compared to their larger competitors. Unsurprisingly, the bank employees’ union, the Finance Sector Union of Australia (FSU), was opposed to any repeal of bank merger controls on the grounds of employment. The FSU argued that job losses and service reductions would particularly affect rural areas (Finance Sector Union of Australia 1996). Likewise the peak agricultural lobby, the National Farmers Federation, and state lobbies such as NSW Farmers, were opposed to bank mergers on the grounds that it would reduce services in rural areas (National Farmers Federation 1996; NSW Farmers 1996).

How should we characterise the establishment of the Four Pillars policy in an institutional framework? The observation of Lewis (1997b) that the Wallis inquiry was driven by the same concerns as the 1937 Royal Commission is significant. The 1990s saw an increase in perceived disorder costs of the size of banks, disorder costs which included the unemployment effects of bank mergers in regional areas, as well as the concerns about the political and economic power of the banks that had developed since the 1990 recession. These changes in perceived disorder costs consequently moved efficient point on the IPF further towards regulatory control, making the perceived dictatorship costs of political discretion less of a concern.

Neither Paul Keating’s Six Pillars policy or Peter Costello’s Four Pillars policy was developed and implemented with the intent of managing bank risk. Four pillars assumed a prudential justification only with the global financial crisis. It is indicative that as late as June 2008 APRA was distancing itself from the Four Pillars policy, arguing that it could not “engage in the policy question of whether four pillars is the appropriate policy” (CPD, Senate Standing Committee on Economics, Estimates, 4 June 2008, p. E 127). Yet by March 2009 the Four Pillars policy was being extolled as one of the keys to the strength of
Australian financial institutions by both APRA (Lewis 2009) and the former RBA governor Ian Macfarlane (Robertson 2009). This emphasises the need to identify path dependencies in policymaking and justification, which, in the next chapter, will be considered in the context of bank deposit guarantees and the idea of the need for a “safe haven” for bank depositors.
10 ARE BANKS STILL SPECIAL? SAFE HAVENS, BAILOUTS AND GUARANTEES, 1990-2008

10.1 Introduction
This chapter looks at three interrelated concepts about prudential regulation which came to be central to the Wallis inquiry and underpinned the policy framework governing banking regulation in the first decade of the twenty-first century. The first is whether banks are “special” in the context of the Australian financial system. The second is the notion that prudential regulation should ensure uninformed depositors have a “safe haven” for their funds. The third is the idea that financial regulation ought to be driven by the principle of competitive neutrality. This family of concepts interacted with each other to create the regulatory bargain that reinstated the Australian bank deposit guarantee under the Rudd government. While the Wallis inquiry collapsed the categories of ‘banks’ and NBFIs into the category of authorised deposit institutions (ADIs), it nevertheless argued that banks ought to maintain their privileged position in relation to the other ADIs. One reason for this differential approach was that the principle of competitive neutrality, which had been a policy goal since the Campbell committee, was in tension with the idea that the government must ensure the existence of a safe haven for uninformed depositors. This chapter explores how these ideas informed and drove the reinstitution of the bank deposit guarantee.

Banks have occupied a special place in the Australian financial system for historical and constitutional reasons. Yet that institutional trajectory does not necessarily imply that banks have fundamental economic characteristics which make them different from other financial institutions. In the view of Tobin (1963), differences between banks and other financial institutions are differences of degree, rather than differences of kind. Fama (1980) argues that under a pure laissez faire regime banks supply transaction services and their portfolio management would be governed by the Modigliani-Miller (1958)
theorem. However, the fact that reserve requirements are imposed on banks under a system of fiat currency produced monopolistically by the government gives them a special role in the determination of prices. Fama (1985) concludes that banks reduce the information costs in assessing the credit-worthiness of borrowers. In this perspective, banks are special because they employ “the old fashioned country bank manager who ‘kicked the tyres and drank with small businessmen at the RSL after work’” (Harper and Phelps 1991, p. 112).

By contrast, the regulatory perspective emphasises the characteristics of banking that demand special regulatory attention. In the view of Gerald Corrigan (1982), at that time president of the Federal Reserve Bank of Minneapolis, banks are special for three reasons. First, unlike other institutions, banks offer transaction accounts payable on demand. Second, banks provide liquidity for the rest of the financial sector. Third, banks are the “transmission belt” for monetary policy. Corrigan argued that the special attributes of banks and their distinction from other financial institutions needed to be preserved by regulators. Two decades later, Mark W. Olson (2006), a member of the Board of Governors of the Federal Reserve, maintained that while the monetary policy function of banks had been reduced, and banks were no longer the central liquidity providers of the financial market, banks “are expected to be very resilient”. In this view, the need to ensure bank stability and depositor protection made banks special targets for regulatory intervention.

This chapter first outlines the financial crisis of 1990 and the weaknesses that crisis exposed in bank failure resolution and depositor protection. Collapses in the NBFI sector directed attention to differences in regulatory burdens across the financial sector as a whole, confused lines of regulatory responsibility, and the ambiguity of an implied deposit guarantee in the banking and NBFI sector alike. Second, the chapter details how this specific experience of crisis was reflected back in discussions about
the principles which underpinned depositor protection – particularly the interaction between the principle of competitive neutrality and the principle of depositor safe havens. The fraught relationship between these two ideas became manifest in tensions within the Wallis inquiry as well as the post-Wallis regulatory settlement.

The chapter returns to the question of deposit guarantees as a concrete manifestation of those tensions. As Chapter 4 found, the Curtin-Chifley government introduced what was understood at the time to be an unlimited government guarantee of bank deposits in private banks. However, the ambiguous legislation which enacted that guarantee, and the fact that the relevant provisions were never tested, meant that this policy was forgotten within a few decades. By the late 1970s the RBA had an established policy of letting insolvent banks fail – contrary to the intent of the 1945 Banking Act – and Australia’s bank deposit guarantee was understood to be implied rather than explicit. The Wallis inquiry sought a compromise between the political incentives brought about by the failure of a financial institutions and the prevention of moral hazard. The Howard government rejected that compromise, instead confirming the implied deposit guarantee status quo. But with its bailout of HIH policyholders in 2001 the Howard government changed course on the deposit guarantee, beginning a process which would lead to the establishment of a formal deposit guarantee scheme under the Rudd government.

Finally, the chapter concludes with a political economy analysis of the trade-offs between a rules-based deposit guarantee and a guarantee based in discretion. This analysis allows us to look with greater clarity at the original Chifley-era guarantee and the way that guarantee was lost, by framing it as the consequence of discretion embodied in statutory ambiguity.

10.2 Financial instability in the 1990s
The 1990 recession precipitated a wave of financial failures and near failures. Here I consider the collapse of the Pyramid Building Society and the takeover of the State Bank of Victoria. These were not
the only major failures in the period – for example, the collapse of the State Bank of South Australia had significant consequences for South Australia’s economy. This chapter looks specifically at the Pyramid Building Society and the State Bank of Victoria because their failures exposed gaps and confusions in the national supervisory structure that maintained divisions between banks and NBFIs, and between federally regulated institutions and state regulated institutions. These failures provide the context for the federal takeover of NBFI regulation recommended by the Wallis inquiry - a policy for which there had been political agitation since the 1950s - and ultimately, after the 2001 collapse of HIH Insurance, sparked the process which established Australia’s formal statutory deposit guarantee. They also provide an illustration of the weakness of supervision and failure resolution practices at the time.

10.2.1 The collapse of the Pyramid Building Society

The Pyramid Building Society collapse in the first half of 1990 made visible the confused lines of regulatory responsibility for prudential control between the Commonwealth and the states. Established in 1959 as a permanent non-terminating building society, the Pyramid was the largest building society in Victoria. It was one of a number of building societies owned by the Farrow Group, and in 1989 and early 1990 was surrounded by rumours of low quality lending practices. The RBA described the Pyramid’s activities as having “entrepreneurial flavour quite different to the activities of traditional building societies” (cited in Habersberger 1996, p. 1321).

The first run on the Pyramid occurred on 12 February 1990. The next day the Victorian treasurer put out a statement that was widely interpreted as offering a state government guarantee of depositor’s funds (Habersberger 1996). The statement also misleadingly suggested that the RBA was willing to stand behind the Pyramid. In fact, the RBA’s established position, which it had taken since the crises of the 1970s, was that it was willing to provide liquidity to banks that were supporting well managed building

The troubles in Pyramid and the Farrow Group precipitated a broader financial crisis in Victoria. On 17 July 1990 the RBA was forced to make a statement in support of the Bank of Melbourne, which was suffering a short-lived run. The Bank of Melbourne had only become a fully-licensed bank under Commonwealth supervision in July 1989; until that time it was the RESI-Statewide Building Society, and the bank’s executives speculated that this history might have contributed to rumours of its instability (Gowdie 1990). There were also spill-over crises at Estate Mortgage, the OST Friendly Society and Metway Bank. The crisis in these state based institutions led to a clamour for regulatory change. Critics pointed to perceived inadequacies in state supervision (Gill 1990; Kohler 1990a, 1990b; Lloyd 1990a; Rogers 1996). The Australian Financial Review (26 June 1990, p. 16) editorialised that “[t]he fact that such runs could occur on the basis of mere rumour - and even then despite extraordinary reassurances from the Government about the health of Farrow and its subsidiaries - underscores public scepticism of any financial entity supervised by the State”.

Perceived deficiencies in Victoria’s NBFI regulation led to political pressure for Commonwealth involvement. In July 1990, the day after the most serious concerns about the Bank of Melbourne the federal opposition leader John Hewson proposed a national “integrated” system of prudential supervision that would encompass NBFI. In Hewson’s view, this could be done through a standardised agreement with the states, or through the proclamation of the still-dormant Part IV of the Financial Corporations Act (Burrell 1990b). Hewson also placed depositor protection on the political agenda, demanding an inquiry that would look at “measures which may be necessary to improve the degree of protection afforded to depositors in financial institutions in Australia” (Hewson 1990). In November
1990 the Democrats introduced a private members bill to the Commonwealth parliament that would have proclaimed Part IV and imposed Commonwealth capital adequacy standards on the building societies and credit unions. The legislation did not proceed.

The drama of the Victorian crisis did not lead immediately to NBFI supervisory reform. Both Paul Keating and Bob Hawke, for their part, were eager to distance the Commonwealth government from the events in Victoria, laying as much blame on the Cain government as they could. This reflected the fraught political relationship between the two Labor governments (Ramsey 1990). Keating ruled out a federal takeover of NBFI supervision throughout the crisis (Burrell 1990a). Likewise, both the Commonwealth government and the RBA rejected the possibility of proclaiming Part IV. The RBA considered that to bring small societies into the central banks’ supervisory tent would be unnecessary as the RBA’s remit was the stability of the financial system as a whole, rather than all financial institutions. The depositor provisions of the Banking Act only applied to banks. Bolstering this argument, the RBA did not have the resources needed for such an expansion into new responsibilities.

10.2.2 Dealing with NBFI failure

However, the question of how state and federal governments should respond to troubled NBFIs and state banks, which were also supervised by state authorities, remained. The Campbell committee had argued that small financial institutions ought to be allowed to fail. The state supervision of building societies and credit unions provided a threshold by which an institution could be judged as systemically important for the financial system. Yet state governments had their own ideas about their responsibility for troubled institutions. This was particularly evident during the Pyramid collapse. Despite the ambiguous statement of support released by the RBA and early claims made by the Victorian government, the Victorian premier John Cain maintained between March and July 1990 that the
Pyramid was not guaranteed by the state government. However, Cain faced political pressure to revise this position (Skulley 1990a). Depositors mobilised in street rallies and the press carried tales of hardship. Other pressure came from within the Labor party, that placed his leadership of the government at risk unless he acted to support the Pyramid’s depositors. Finally buckling to these external and internal forces, two days after the Pyramid closed its doors Cain announced that the state government would guarantee that the 200,000 depositors in Farrow Group building societies would receive 100 per cent of their deposits back “eventually” (Freeman 1990).

This guarantee of Farrow Group depositors by the Victorian government gave Australia’s deposit guarantee a new shape and a new precedent. State building society legislation did not offer any guarantee of deposits. Yet the belief that such a guarantee existed was sufficiently widespread for the press to assert that state regulators “ensure that if a building society or credit union goes under the depositors will get their money back” (Kane and Kaufman 1993, p. 25). Cain implicitly accepted this argument when he had suggested during the crisis that the Farrow Group’s aggressive financial entrepreneurism meant that it could no longer be considered a building society at all (Gill 1990). The implication here was that it was ineligible for any implicit guarantee offered by the state government. Further complicating the wind up of Pyramid was the fact that many “depositors” in fact held not deposits but non-withdrawable investing shares. There were widespread claims these shares had been sold on false pretences (Habersberger 1996). The Pyramid collapse forced policymakers to clarify what responsibility they had to building society depositors. Gittins (1990) noted that

There is no legal guarantee of building society deposits. But, until now, there has always seemed to be an implicit guarantee. For years, investment advisers and financial journalists have been able to assure people that, in practice, their money was as safe in a building society as it was in a bank. That assurance was based on the belief that no Premier would ever allow any doubt to be cast on the
security of the deposits of the building societies for which he was responsible. John Cain may have relented, but the damage is done. A different precedent has been added to the record. People want more than an assurance that they'll get their money back some day.

10.2.3 The collapse of the State Bank Victoria

A further precedent was set by the collapse of the Victorian government-owned State Bank Victoria (SBV), the fifth largest bank in the country. The SBV had been encouraged to be more entrepreneurial by the Cain government, and purchased the merchant bank Tricontinental in 1985. Tricontinental lent aggressively to high risk clients - the so-called corporate cowboys of the 1980s (Sykes 1994). The bank was highly dependent on short term financing and a low capital base. Having accumulated an excess of bad debts, in May 1989 the SBV put a halt to Tricontinental lending, took over its liabilities, and obtained the resignation of its chief executive, who was subsequently arrested for a range of financial offenses two months later. The closure of Tricontinental left the SBV with $2 billion total losses by August 1990, “probably the biggest money pit in Australian financial history” (Skulley 1990b). The RBA offered the SBV conditional emergency liquidity and to buy if necessary its portfolio of Commonwealth securities. Ultimately the SBV was rescued by a sale to the CBA. The sale excluded the Tricontinental liabilities and was buttressed by a financial support from both the Victorian and Commonwealth government. The deal, announced on 26 August 1990, was managed by the RBA. This financial drama coincided with the CBA’s partial privatisation, which was approved by the federal Labor caucus two days later.

The SBV collapse further exposed the unclear prudential lines of responsibility in the Australian financial system. Keating, like many commentators at the time, attributed the SBV collapse to the fact that it was not supervised by the RBA (Scott 1990). Yet while the RBA had no statutory role over state banks, it did have supervisory relationships with the state banks through a system of voluntary agreements. In June 1986, one such voluntary agreement was established between the SBV and the RBA. As the Royal
Commission into the Tricontinental Group of Companies (1991, 1992) found, the supervisory consequences of this were both opaque and confused.

There was confusion about the lines of responsibility along two dimensions. The first confusion concerned the direct supervisory scope of the RBA. While the RBA maintained that its supervision of state banks under voluntary agreements was “as effective” as those supervised under the Banking Act, the fact that such supervision was voluntary meant the RBA “felt somewhat constrained in cracking the whip” (Royal Commission into the Tricontinental Group of Companies 1992, p. 756). For their part, state governments misinterpreted the depth of that supervision, assuming it was more rigorous than it was (Standing Committee on Finance and Public Administration 1991, p. 191). The second confusion was the RBA’s responsibility for Tricontinental as a State Bank Victoria subsidiary. Supervisory interest in the affairs of NBFI subsidiaries grew in tandem with RBA’s focus on prudential supervision itself. In 1988 the RBA established a financial institutions department to monitor the NBFI sector. This department drew up a watch list of merchant banks of questionable stability, based on information acquired as part of the Financial Corporations Act and publicly available reports. Tricontinental was on one of those lists. The RBA consulted with SBV about Tricontinental “on a number of occasions” starting in 1986 (Royal Commission into the Tricontinental Group of Companies 1991, p. 438; 1992, p. 763). However the central bank’s concern was never substantial enough to warrant imposing heavier prudential requirements on SBV, apart from pressing SBV to improve its group-wide capital ratio to compensate for Tricontinental’s activity.

The hands-off nature of this approach may have been well-understood by the RBA and SBV, but it was not well understood by the Victorian government. Both John Cain and the Director-General of the Victorian Department of Management and Budget appear to have been unaware that the RBA
distinguished in its supervisory practices between banks and their NBFI subsidiaries. The Royal Commission into the Tricontinental Group of Companies (1992, p. 765) admonished that

The RBA should have been aware that its supervision of SBV was regarded by overseas authorities as well as the State Government and Australian financial circles as of real importance in providing reassurance that its prudential requirements were being observed.

10.3 Instability and institutional change

The gaps in prudential supervision and failure resolution exposed by the financial crisis of 1990 were both legal and conceptual. The voluntary agreements between the RBA and the state banks were an attempt to work around the Australian Constitution’s allocation of responsibilities for banking. Likewise the division between control of banks and NBFI was determined by constitutional circumstances. The RBA’s hesitant moves on state bank and NBFI supervision were a reflection of the two competing facts of continued constitutional uncertainty and the obvious prudential significance of NBFI activity for their parent companies. The situation was complicated even further by conceptual issues. Cain argued that Pyramid was acting quite unlike a traditional building society. The SBV was encouraged to be entrepreneurial, unlike the safe and stable state banks of the past. Blurred lines between financial institutions had been a problem since the 1970s. But in 1990, after a decade of regulatory and corporate innovation, it should have been no surprise that policymakers were unclear about the exact lines of responsibility for financial institutions not directly regulated by the Commonwealth’s Banking Act.

By 1990 the divisions between financial institutions were less distinct than they ever had been. Between the Campbell inquiry and the Wallis inquiry two-thirds of building societies, representing three quarters of building society assets, converted from building societies to banks (Thomson and Abbott 1998). The decision to do so was driven by the differential regulatory environment afforded by the Banking Act. State supervised building societies were still subject to many asset limitations and restrictions on inter-

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state branch expansion. Converting to ‘banks’ regulated under the Banking Act freed them to pursue more aggressive, national strategies. Furthermore, assuming the legal status as a bank allowed them to take advantage of the regulatory bargains negotiated between the federal government and the banks - such as the 1989 deal between Keating and the banks to pay interest on NCDs in exchange for increased lending. By the late 1980s, the cost of complying with state NBFI regulation was seen as unattractively high (Condon 1992; Freeman 1992; Kaye 1992; Lewis and Gill 1992; Stanford 2004; Thomson and Abbott 1998).

The unhappy experience of 1990 gave new momentum to the decades old push for greater interstate cooperation and federal involvement in NBFI.s. In the absence of firm and well-understood principles by which the RBA and state authorities could expect supervision to occur and failures to be resolved, policymakers relied on their discretionary decision-making power to negotiate their way through the crisis. Ambiguity about the strength and applicability of a Victorian building society deposit guarantee meant that Cain could vary the promise according to political circumstances. Widespread awareness of this discretion placed his leadership in jeopardy and the uncertainty it engendered probably contributed to the severity of the crisis (Kane and Kaufman 1993).

10.3.1 Uniform national prudential regulation before Wallis

While Keating dismissed Hewson’s proposal that the states forge uniform prudential standards, the Hawke government nevertheless promised to raise the issue at a special premiers’ conference in October 1990 (Burrell 1990b; Ramsey 1990). However, it was not until 1992 that a system of national supervision was developed. The premiers’ conference considered a scheme of regulation that would require no Commonwealth involvement but be based on the RBA’s approach to banking supervision. A ‘National NBFI Board’, would act as an umbrella supervisor, liaising with the RBA, with the power to
inspect and request information from NBFIs. The board would consist of representatives from state NBFI supervisors, who had the responsibility of licensing building societies and credit unions. Under this scheme any financial firm “wishing to expand outside their primary objective could be encouraged to apply for, say, a banking licence or convert to a company to carry on business as a finance company under the companies code” (Cleary 1990). A Queensland government report into NBFI regulation in that state, which reported in November 1990, fleshed out this possible system for nationally coordinated NBFI regulation (Committee of Inquiry into Non-Bank Financial Institutions and Related Financial Processes 1990).

The establishment of uniform prudential supervision for building societies and credit unions, and the Australian Financial Institutions Commission (AFIC) was highly fraught. First the Hawke government had to defeat a move at the ALP conference in June 1991 to include in the party platform a clause that would require direct RBA supervision of state banks and NBFIs (Dodd 1991). Second, each state had to sign off on uniform legislation. Public spats between the states slowed down this process. Each state had to contribute financially towards the AFIC’s budget. While the AFIC opened its doors in July 1992, its budget was not finalised until five months later (White 1992). Under the uniform Financial Institutions Act 1992, the AFIC determined national standards to be implemented by state supervisory authorities (Gray 1993). The act imposed capital adequacy requirements arranged in two tiers of high-quality capital and supplementary capital. This scheme closely followed the Basel I model which had been adopted for banks. The liquidity requirements mirrored the prime assets requirement. The Financial Institutions Act differentiated between building societies and credit unions, requiring that the former grant least 50 per cent of their loans for residential housing and the latter limit membership and grant 60 per cent of their loans to members. The stringency of capital and liquidity ratios differed for each institutional category (Stanford 2004). Finally, regulated NBFIs were expected to pay a supervision fee to the AFIC. As Stanford
(2004) demonstrates, the long term consequence of the Financial Institutions Act was to hasten the conversion of NBFIs into banks, as the high cost of supervision combined with the strictures of maintaining status as a building society or credit union were prohibitive.

Two final developments signalled the attention being paid to cross-sectoral prudential risk. The first was the creation of the Council of Financial Supervisors (CFS) in 1992 as a peak body of financial regulators, including the RBA and the AFIC, as well as the Insurance and Superannuation Commission and the Australian Securities Commission. The purpose of the CFS was to facilitate co-ordination between supervisors given the trend towards financial conglomerates (Standing Committee on Finance and Public Administration 1991, pp. 233-4). The second development was the 1993 establishment of the Australian Payments Clearing Association, which gave foreign banks and NBFIs direct access to the payments system. Previous to this, the non-banks and foreign banks would need to have their cheques settled by the domestic major banks. The 1993 reforms effectively rewrote the criteria for direct access to the clearing house so that it was not based on institutional categories but on prudential standards.

10.4 Competitive neutrality and the “safe haven”
These changes foreshadowed the Wallis inquiry’s reassessment of the distinctions between financial institutions – the distinctions between banks and NBFIs – that had shaped Australian financial history since federation. Yet the Wallis inquiry’s attempt to overlay the Campbell committee’s doctrine of competitive neutrality onto an actually-existing financial system came up against a number of cultural and political constraints. To explore this, it is necessary to return to the Campbell committee again and look how that inquiry conceived of the special status of banks and their role as a “safety haven” for unsophisticated depositors.
10.4.1 Competitive neutrality in the Campbell committee

If competitive neutrality was the “conceptual pivot” (Congdon 1982) of the Campbell committee’s final report, then what did it mean by competitive neutrality? The Campbell committee considered three approaches to competitive neutrality (Committee of Inquiry into the Australian Financial System 1981, pp. 4-5). The first was that all financial institutions be subject to the exact same regulatory controls, which it rejected on the grounds that there was such a wide variety of products and institutions doing so would be infeasible. The second was that different institutions faced different regulatory controls but the “balance” of the burden of regulation was equivalent across institutional types. This was rejected on the grounds that the balance would be in practice too hard to achieve. The third option was what it described as functional regulation: “functionally similar operations could be subject to similar regulation”. This approach the Campbell committee favoured in principle. Institutions which offered similar products would be subject to “comparable monetary and prudential” regulation. The obvious example here was building societies and banks, both of which offered household deposits. Regulation would then vary according to the institution’s assets and “general perception of risk”. However, the committee cautioned,

> It is, of course, true that it is not always easy to draw precise lines around different “activities” or segments of the market. Ultimately, every borrowing or lending activity is in competition with every other and this will be especially true in the more integrated financial system envisaged by the Committee. (Committee of Inquiry into the Australian Financial System 1981, p. 5)

Competitive neutrality was neither consistently nor unflinchingly applied (Congdon 1982; Valentine 1983). The most significant violation of competitive neutrality was the Campbell committee’s treatment of banks. Under its proposed framework, banks were to retain the SRD ratio for its use in monetary policy. Yet the maintenance of the reserve ratio in the SRD requirement was not applied to NBFIs - even
those which were in direct competitors of banks. “This a conspicuous and unjustified departure from the principle of competitive neutrality” (Congdon 1982, p. 104). Likewise prudential controls were defined not on the basis of the products offered by a financial institution but according to their institutional categorisation, and banks were seen as special for prudential purposes (Hogan 1982; Sharpe 1982).

The Campbell committee believed banks were special because they had a unique role in the payments system, were systemically important, and “it is widely accepted that there is a need for a safety haven for small investors, a role that has traditionally been filled by the banks” (Committee of Inquiry into the Australian Financial System 1981, p. 296). This need for a “safety haven” was not a closely examined principle. Indeed, the Campbell committee noted that it “does not question” the need for safety havens for “small, risk-averse investors” (Committee of Inquiry into the Australian Financial System 1981, p. 4). It also recognised that formalising this “safety haven” role of banks constituted a departure from competitive neutrality and justified the retention of the depositor protection provisions of the Banking Act (Committee of Inquiry into the Australian Financial System 1981, pp. 288, 311).

10.4.2 The “safe haven” for depositors

The concept of a risk free “safe haven” for depositors was not new in 1981. We can trace the political demand for a safe haven for depositors back to the establishment of the Commonwealth Bank in 1911 (Gollan 1968; Thomson and Abbott 2001). When political actors referred to the depositor protection and guarantee provisions in the debates over the Banking Act in 1945, they emphasised that the legislation ensured “the public shall be protected against ... losses” (CPD House of Representatives, 21 June 1945, p. 3468). After the Campbell committee, the Martin Group also used the “deep-rooted community perception” of banks as safe havens in order to justify its distinction between banks and NBFIs (Australian Financial System Review Group 1984, p. 131). As the 1990 Victorian crisis was to show,
a similar perception could also develop for building societies. As Carron (1984) noted, that there was nothing in the concept of a safety haven that would exclude NBFIs from offering similarly risk-free deposit services.

The contribution of the Campbell committee’s relatively systematic approach to financial regulation was to detail exactly the contribution that safety haven considerations played in financial regulatory philosophy. The Campbell committee spoke of the need for ‘risk-free’ assets. But banks earn their profit through the management of risk and risk sharing (Diamond and Dybvig 1983; Freixas and Rochet 2008; Heffernan 2005). As the Wallis inquiry pointed out, “One of the vital economic functions of the financial system is to manage, allocate and price risk” (Financial System Inquiry 1997, p. 190). Investors that sought risk-free investments could purchase government securities. It is hard to see how the effective elimination of risk without a degree of government support. Further elaboration of the safe haven principle was provided by the Pocket Full of Change report, with its close emphasis on retail banking and consumer issues. In the Standing Committee’s view, there was an a priori need for secure and safe place for deposits. The committee wrote approvingly that “some argue ... safe havens are needed in their own right, to underpin the effective working of a market economy” (Standing Committee on Finance and Public Administration 1991, p. 211).

[i]t is important to take into account the need in any society for at least one ‘safe haven’ for consumer deposits. Consumers need safety from institutional collapse. In Australia, that need is fulfilled by banks. (Standing Committee on Finance and Public Administration 1991, p. 451)

In this way, the argument for safe havens is conceptually distinct from market failure arguments for prudential regulation. The safe haven argument is independent of claims as to the opacity of banking contracts, the externalities caused by banking runs, the monetary consequences of banking activities, or
liquidity mismatches. Rather, it refers to a political demand for risk-free deposits. An internal Fraser Cabinet document noted that it was the “community perception” of the special status of banks that was at stake as much as general confidence in the financial system (NAA A12909 5656). Likewise, an RBA conference on the eve of the Wallis inquiry distinguished between two views of the goal of prudential regulation. The first was the need to protect against systemic risk and liquidity crises – fundamentally a market failure question. The second was fundamentally a political incentives question:

The second main view of regulatory policy was that the essential rationale came from the political imperative to protect depositors. Policy could not take a disinterested view of any loss of depositors’ money, and there was a strong public demand to have some core of safe assets that could be held by risk-averse savers. (Sherwin 1996, p. 250)

10.4.3 Safe havens and the Wallis inquiry

The Wallis inquiry sought to put some meat on the bare bones of the safe haven argument. The inquiry promised two conceptual advances in the practice of prudential regulation. First, it would recommend closer adherence to functional regulation than the Campbell committee had been able or willing to go. In this it was assisted by the fact that the practice of monetary policy and the monetary toolkit had greatly evolved since the late 1970s, meaning that banks no longer held a unique role in the process of monetary management. Second, it would recommend a framework that would offer more regulatory consistency and greater competitive neutrality.

In order to achieve these inter-related goals, the Wallis inquiry adopted what it described as an ‘intensity of promise’ approach. Each financial product implied a degree of certainty and a level of risk. For instance, deposits and payments had a high intensity of promise as they were not expected to be vulnerable to credit or market risk. The Wallis inquiry argued that prudential regulation should be
tailored to the intensity of promise of each product. Intensity was determined by three factors that reflected the relative risks involved:

- the inherent difficulty of honouring promises;
- the difficulty in assessing the creditworthiness of promisors; and
- the adversity caused by breaching promises. (Financial System Inquiry 1997, p. 190)

The higher a financial product rates on those three characteristics, the higher intensity it was considered. Thus rather than a binary distinction between banks and NBFIs, regulation – as well as the implied guarantee that regulation provided – would exist on an institutional gradient, from full market discipline to highly regulated and protected. A financial product with more intense promise characteristics would be subject to more intense regulation.

However, in many ways the intensity of promise distinction offered more “functionality” than the Wallis inquiry was prepared to support. Prudential regulation was not applied to individual products but to institutions. A product’s intensity of promise was relevant insofar as regulation would apply to an institution on the basis of the highest intensity of promise that institution offered. For instance, as banks offered deposits, they would be subject to most intense regulatory oversight. Brown and Davis (1997) note that rather than ensuring competitive neutrality this would discriminate against the provision of low intensity of promise products in firms that also offered high promise intensive products. Such discrimination could be resolved by firms establishing holding companies that split different products into different institutions but “it is unlikely the general public will appreciate the subtleties of such structural arrangements” (Brown and Davis 1997, p. 311). The result was that the “functional” approach regulation and the “institutional” approach converged more than the Wallis inquiry was willing to admit.
The Wallis inquiry’s adoption of functionality in regulation was an attempt to erase the distinctions between banks and NBFI. Yet even here ensuring competitive neutrality was problematic. The Wallis inquiry proposed that prudential regulation be separated from the RBA and its responsibility given to a new body, the Australian Prudential Regulation Commission (APRC). The APRC would license all “deposit taking institutions” (DTIs) - banks, building societies, credit unions and mutuals - while allowing each to maintain their distinctive generic titles. While only firms which were mutually owned would be allowed to use the titles ‘credit union’, ‘credit society’, or ‘mutual’, there would be no such restriction on the use of the phrase ‘building society’.

In this sense the Wallis inquiry had a clear answer to the question of whether banks are special. Banks allow deposits and it is deposits, with the maximum intensity of promise of any financial product, that are special. But as other financial institutions also allow deposits, the principle of competitive neutrality demands that those institutions be brought into the highest level of prudential regulation as well. Nevertheless, even under this new framework banks were to retain some distinct features which went beyond terminological distinctions. The Wallis inquiry recommended that banks be subject to minimum capital requirements “from time to time” (Financial System Inquiry 1997, p. 44) and that only institutions which held exchange settlement accounts with the RBA - which since the 1993 reforms to the payments system could now include foreign banks and NBFI - would qualify as banks. The Wallis inquiry thereby rejected one of Campbell’s justifications for the specialness of banks - their inherent systemic significance, leaving questions of systemic stability to monetary policy and the RBA - but maintained their distinct role in the payments system and as the providers of safe havens for depositors.

10.5 From safe havens to deposit guarantees
Thus the Wallis inquiry maintained a formal difference between banks and NBFI, albeit a much reduced one. Brown and Davis (1997, p. 313) note that much competitive advantage conferred on banks would
be lost under the ADI distinction but the perseverance of banks’ unique regulatory position in the payments system would “do little to dispel the notion that banks are special”. The Wallis inquiry was particularly alive to the role that perception played in questions of banking and NBFI stability. Wallis tried to draw a bridge between the political demand for a safe haven for deposits and the requirements of competitive neutrality. However the clear rules it attempted to draw around popular perceptions of an implicit political guarantee of deposits were very quickly blurred by the Howard government in its response to the inquiry.

A deposit guarantee or insurance scheme found little support in the submissions to the Wallis inquiry. For instance, KPMG (1996, p. 8), National Australia Bank (1996, pp. 6-4) and the Australian Bankers’ Association (1996, p. 114) noted the moral hazard consequences of a deposit insurance scheme. Particular reference was made to the Savings and Loans crisis in the United States between 1986 and 1995, which was seen as a direct result of the moral hazard created by the Federal Deposit Insurance Corporation. Colonial (1996) argued that deposit insurance would be both ineffective and costly, with consumers bearing the cost. One submission that did support the introduction of deposit insurance was provided by the Commonwealth Department of Industry, Science and Tourism, which argued that explicit deposit insurance would help distinguish between safe deposits and riskier financial products within the same institution (Financial System Inquiry 1996, p. 284).

The Wallis inquiry came down firmly against deposit guarantees. Its preliminary discussion paper, published in November 1996, spent some time canvassing the options regarding deposit guarantees and deposit insurance schemes and suggested that it would comprehensively review the desirability of such a scheme in Australia (Financial System Inquiry 1996, pp. 286-7). The final report rejected a deposit insurance scheme, in part because of the unhappy recent experience in the United States, arguing that
“poorly designed deposit insurance schemes are worse than none at all”. The inquiry cited “public resistance” to deposit insurance in the wake of the savings and loan crisis as one reason it was undesirable (Financial System Inquiry 1997, p. 355).

As an alternative to deposit insurance or guarantees, the Wallis inquiry recommended the extension of depositor preference - which had been introduced for banks by the 1945 Banking Act - to all ADIs. Depositor preference would not provide a 100 per cent guarantee that depositors would receive their funds back in the event of a collapse (Gray 2004). While deposits are only a small part of the liabilities of Australian ADIs, this would not necessarily be the case after a failure: bank failures are typically slow enough for non-depositors to liquidate their holdings early. The weakness of depositor preference as a form of assurance for safe haven deposits is illustrated further by a consideration of the possible information asymmetries between regulators and the public. As Currie (1998) points out the Wallis inquiry gave the new prudential regulator the formidable task of explaining to the public the distinction between the implicit deposit guarantee that was assumed to be existent before the inquiry and the new system of depositor preference for all ADIs.

As this suggests, central to the Wallis inquiry’s recommendations was a clarification of the scope of protection for depositors. The separation of prudential regulatory authority from the RBA and into the APRC was implicitly intended to reduce the potential for direct support in the event of a failure, as the prudential regulator would lack the finances to offer such support (Financial System Inquiry 1997, pp. 313-4; Valentine 1997). Furthermore, the Wallis inquiry wanted the absence of a deposit guarantee to be made specific, and to be given statutory form:

[I]t should be made clear that the resolution arrangements are not intended to confer any form of guarantee over deposits. The legislation should be clarified to ensure that depositors have no
recourse to the APRC and that the APRC has no obligation to make good any losses incurred by regulated institutions. (Financial System Inquiry 1997, p. 356)

As one Wallis committee member, Bill Beerworth, told a function a week after the release of the report,

All the inquiry has done is to highlight the fact that at the moment there is no guarantee ... In theory it's always been a political guarantee. We think that should be made clear. (Gray 1997)

10.5.1 The Howard government maintains the implicit guarantee

Yet the Howard government made no effort to limit the scope of the implied guarantee of bank deposits. In the official response to the Wallis inquiry in September 1997, Peter Costello made a conspicuous decision not to clarify the guarantee’s status, proclaiming that “[t]here will be no lessening of protection for bank deposits from that which is currently provided” (Costello 1997), followed by a discussion of the extension of depositor priority to all ADIs. This statement was highly ambiguous, and it entrenched rather than eliminated the uncertainty surrounding the state of the deposit guarantee.

Given that traditional bank competitors such as credit unions and building societies were now to have the regulatory protection granted to banks, NBFIs could be assumed to have the same implicit guarantee as banks had enjoyed. While the regulatory restructure that the Wallis inquiry believed would eliminate the implied guarantee was introduced, the Howard government declined to take the further step of clarifying the guarantee’s absence. This would have not come as a surprise to the RBA, which had presciently warned the Wallis inquiry that

It is hard to believe that ... democratically elected governments will (or should) stand by and watch a large number of citizens (and voters) lose money they thought was relatively safe. This inability of governments to “credibly pre-commit” means that they probably cannot remove the perception of depositor protection even if they want to. (Reserve Bank of Australia 1997, p. 33)
Thus, unsurprisingly, for all the effort given by the Wallis inquiry to clarify the status of the guarantee, the situation after the Wallis reforms was almost exactly that which preceded it. The newly constituted Australian Prudential Regulation Agency adopted the interpretation of the Banking Act that it had inherited from the RBA.

Despite the existence of widespread myths to the contrary, the Banking Act does not provide depositors with a guarantee that their deposits will be repaid. While APRA’s responsibility is to protect depositors, in most cases this will require early action to prevent financial distress and, where distress still occurs, early action to find a buyer. (Goldsworthy, Lewis and Shuetrim 2000, p. 25)

Gray (2004) and Quiggin (2002) both identified the continued implicit guarantee shortly after the Wallis inquiry, and a 2005 World Bank database into deposit guarantees identified Australia as one of the ten high income countries with such an implicit guarantee (Demirgüç-Kunt et al. 2005). A paper by RBA researchers published just two years after the Wallis reforms asserted that the inquiry had failed to address whether the government would bailout retail depositors in a failed bank, and concluded that “political pressure could lead to a guarantee of all deposits in a failed institution” (Gizycki and Lowe 2000, p. 205). This lack of clarity was reflected in a 2006 survey conducted by the RBA which found that 60 per cent of Australians believed that the government guaranteed deposits held by banks, building societies and credit unions or was likely or highly likely to step in to ensure full or partial repayment of deposits in the event of a failure (Reserve Bank of Australia 2006).

10.6 The turning point: the bailout of HIH policyholders
The Howard government surmounted the constitutional barrier to Commonwealth-state regulatory harmonisation with relative ease. Costello sought a referral of power from the states and territories to the Commonwealth, which he obtained within a few months of the release of the Wallis report. The only
holdout was Queensland: the Queensland government wanted the new regulatory authority to be headquartered in Brisbane, outside the “Sydney-Canberra-Melbourne corridor” (Dwyer 1997). This opposition was short-lived. Legislation for the new Australian Prudential Regulatory Authority (APRA) was introduced in parliament in March 1998 and APRA opened its doors (in Sydney) on 1 July 1998. With the passage of the Financial Sector Reform (Amendments and Transitional Provisions) Bill (No.1) 1999, the Coalition affected the Commonwealth takeover of responsibility for NBFIs that so many Labor politicians had called for since the 1950s. As the Minister for Financial Services and Regulation Joe Hockey told parliament, “for the first time in the history of the Commonwealth, there will be a single, consistent, regulatory regime for deposit taking institutions, life and general insurance, and superannuation” (CPD, House of Representatives, 11 March 1999, p. 3821-3822).

Yet the process of regulatory convergence under a functional regulator placed pressure on the new regulatory framework. The collapse of HIH Insurance in March 2001 was a political stress-test of the new regime. HIH was neither a bank nor an ADI, but one of Australia’s largest insurance agencies regulated under the Insurance Act 1973. Responsibility for prudential regulation under that legislation had been transferred to APRA in 1998. The HIH collapse challenged the regulatory framework in two ways. First, it exposed what was seen as weaknesses in the supervision of insurance, which was to be the subject of legislative reform in 2002. Second, it opened a debate on the political responsibility for financial collapses, which was to have repercussions later in the decade.

While we lack access to the Cabinet documents for the HIH collapse that have informed earlier parts of this thesis, enough is known through memoirs and contemporary records to recreate a debate held within the Howard Cabinet about how the government ought to respond to the HIH collapse. The HIH collapse came before the Cabinet shortly after the company went into liquidation. The debate in Cabinet
turned on whether the government should intervene with a rescue package or whether the Wallis Inquiry’s determination that such a bailout would create moral hazard. Joe Hockey argued that those who were left without insurance were “our people ... Liberal Party stalwarts” such as the small business owners who were traditional Liberal constituents (Boyd 2013; King 2014, p. 128). It wasn’t until a Cabinet meeting in May 2001 that the decision to fund a rescue package for HIH was made. The key factor was that the political fallout was threatening to become an issue in the election due that year (King 2014). Ultimately the Howard government announced a more than $500 million support package for HIH clients.

The HIH bailout added to the public perception of an implied guarantee of financial institutions, now encompassing both insurance policy holders and depositors in ADIs. Most pressingly, it also demonstrated the failure of the Wallis compact on depositor protection. The government was too weak to foreswear bailouts either *ex post* or *ex ante*. In its submission to the subsequent HIH Royal Commission, APRA proposed that the government institute formal compensation arrangements for failed institutions (Australian Prudential Regulation Authority 2002). In its view, the post-Wallis reforms had failed to provide competitive neutrality in the event of a financial institution wind-up across institutional categories. This was particularly stark when both firms might be owned by the same financial group but subject to different resolution principles. In the light of the HIH collapse, APRA was also critical of the emphasis the Wallis inquiry placed on depositor priority, noting that such a resolution mechanism introduced “considerable uncertainty in amount and timing” and therefore added to political pressure for extra-statutory intervention. A final reason to look to formalise compensation arrangements was that, in the light of the practical lessons from the HIH collapse, further attempts to clarify the status of the guarantee were unlikely to be effective. APRA argued that
the community does not appear to be willing to accept major losses, especially where these involve individual hardship. Further, the Government’s financial assistance to HIH policyholders is likely to have heightened community expectation that compensation will be made available when an institution fails. We do not believe an education campaign (no matter how intensive) could alter this. (Australian Prudential Regulation Authority 2002, p. 48)

**10.6.1 Momentum towards deposit guarantees**

The HIH collapse was a turning point in the history of prudential policy in Australia. The Wallis inquiry reflected a consensus position on deposit guarantees among policymakers that dated back to the Campbell committee. This consensus saw as the policy ideal the imposition of heavy prudential supervision matched by a denial of any guarantee of deposits: in the often-repeated words of the RBA governor Robert Johnston, under the Banking Act the RBA was the “guardian, not the guarantor” of deposits (Johnston 1985). APRA had been created in part to build credibility for the consensus position. Yet less than three years after the Wallis inquiry reported, the federal government had directly bailed out creditors of a major insurance company and the consensus was in disarray. The new prudential regulator no longer believed that the norms which had been established since the 1970s were compatible with the political incentives created by a financial institution failure. The foundations for the 2008 reversal of decades of rejection of a deposit guarantee were laid in the HIH collapse.

That process began with the release of the HIH Royal Commission in April 2003. The Royal Commission heavily criticised APRA for its supervision of HIH, and recommended a host of reforms to APRA’s internal governance and approach, including further managerial independence from the treasurer. It also sought greater consistency between the Insurance Act 1973 and the Banking Act, and sought to extend the prudential controls on insurance products to “all discretionary insurance-like products” given constitutional constraints. Its most significant recommendation was the establishment of a
Commonwealth scheme “to support the policyholders of insurance companies in the event of the failure of any such company” (HIH Royal Commission 2003, p. lxxv). Considering the Wallis inquiry’s warning about the moral hazard consequences, the commission argued that

the community will not readily accept the huge losses that flow from the failure of a financial institution. Nor should it. The consequence is that governments at all levels come under pressure to respond to such failures. (HIH Royal Commission 2003, p. 290)

In the absence of a formal compensation scheme, the response to these failures would be necessarily *ad hoc* - determined not by any statutory requirement but a constellation of contingent political factors and the discretion of the government of the day. While the Royal Commission accepted that this uncertainty might reduce moral hazard by making firms and policyholders unsure how the government would respond to a financial failure, the Royal Commission believed that it also reduced consumer confidence in the insurance industry and that pressure for policyholder support would remain. A firm *ex ante* rule governing compensation would provide “administrative efficiency, transparency, certainty, and consistency of approach” (HIH Royal Commission 2003, p. 293).

The established principle of competitive neutrality meant that any regulatory change governing insurance would necessitate changes to other financial promises. The Howard government believed that any mechanism for depositor support of insurance policyholders had to be consistent with similar guarantees across the financial sector. In the terminology of the Wallis inquiry, both deposits and insurance contracts had a high “intensity of promise” and should therefore face the same regulatory protection. In September 2003 Peter Costello commissioned the financial economist Kevin Davis for a “comprehensive study” into the possibility of deposit insurance for the financial sector as a whole, with
special reference to the incentive effects, design, and costs (Costello 2003). This report was returned to the government in March 2004.

While the Davis report did not make any explicit recommendations, it laid the intellectual groundwork for a deposit insurance scheme. The report acknowledged that a *caveat emptor* approach, which relied on market discipline to moderate financial decision-making might be the most economically efficient. However, “[t]he success of such a policy stance would depend upon governments maintaining a consistent position” (Davis 2004, p. 37), and Australian governments had not been able to maintain such a position. The political incentive to protect who Hockey described as “our people” (King 2014, p. 128) made the *caveat emptor* approach almost impossible. This was a substantial shift from the position of the Wallis inquiry. The Davis report implied that the Wallis inquiry was too focused on trying to prevent depositors getting the impression of a deposit guarantee while doing little to create disincentives for policymakers to guarantee depositors after the fact of a failure.

Political incentives were not the only factor underpinning Davis report’s qualified arguments for deposit insurance. Davis considered the arguments on system stability following Diamond and Dybvig (1983) as well as the incentive affects that deposit guarantees had on regulator behaviour following Kane and Kaufman (1993). He also hinted at other factors which might lead to a government guarantee: “equity and broader socio-economic reasons” (Davis 2004, p. 37). This was an echo of the safe haven arguments mounted by previous inquiries. Thus while the strictly economic arguments for deposit insurance were of interest, the Davis report put political incentives and political demands at its forefront. An explicit guarantee would offer consumers greater certainty as to the scale and coverage of the guarantee and would help facilitate more timely responses to failure.
The Howard government was not quick to act on the findings of the Davis report. Costello released a public discussion paper that canvassed both the desirability of a deposit insurance scheme and the possible design of such a scheme (Commonwealth of Australia 2004). In November 2005 the Council of Financial Regulators (which succeeded the Council of Financial Supervisors in 1998) recommended the establishment of a “minimalist” deposit insurance scheme. Such a scheme would provide depositors and insurance policyholders with 90 per cent of their funds up to a proposed limit of $50,000. Extra funds would be available “in limited and specified circumstances” depending on the personal circumstances of the depositor and policyholder. The support would be funded by the assets of the institution and any shortfall made up by an ex post levy on other financial institutions (Council of Financial Regulators 2005).

In August 2006 Costello expressed support for a deposit insurance proposal subject to the caveat that it was not to raise consumer costs or lead to moral hazard (Davis 2006). The scheme was to be developed by the RBA in consultation with ADIs and insurers. Yet no final decision had been made on the scheme on the eve of the 2007 federal election (CPD, Senate Standing Committee on Economics, 27 July 2007, p. E 62.)

10.6.2 The Rudd government and the global financial crisis

The election of the Rudd Labor government in 2007 was shortly followed by one of the largest financial crises since the Great Depression. Neither Kevin Rudd nor the new treasurer Wayne Swan had made financial sector reform a major part of their focus in opposition. Their response to the global financial crisis (GFC) was a reinvigoration of Keynesian stimulus policy to boost demand. This was facilitated by a changing perspective towards Keynesian policies within the Treasury department (Taylor and Uren 2010; Uren 2014) as well as a disposition towards positive action that would help the new government avoid the fate of James Scullin, whose hesitancy in the face of the Great Depression was seen to have doomed his first term government.
Nevertheless, the Rudd government’s moves towards a formal deposit guarantee scheme predate the GFC. The new government was simply continuing a policy change which had been begun by the Howard government. Swan (2014) writes that he first met Treasury officials in February 2008 to discuss progress on the recommendations of the Council of Financial Regulators - that is, a few weeks before the collapse of Bear Stearns in the United States began the financial meltdown, and before an April 2008 trip to the United States that convinced him of the scale of the impending crisis. Further influence for a deposit guarantee came from the Financial Stability Forum (FSF), a committee of international banking authorities headquartered at the BIS of which the RBA was a member. In April 2008 the FSF released a report urging national authorities to strengthen deposit insurance arrangements and increase coordination of national deposit insurance schemes (Financial Stability Forum 2008). In June 2008 Swan told parliament as part of a response to the FSF report that the government intended introduce a financial claims scheme that would “provide depositors in authorised deposit-taking institutions and policyholders in APRA regulated general insurers with access to funds in a timely manner in the unlikely event that such a financial institution should fail” (Swan 2008). In this way the Rudd government’s initial steps towards deposit insurance were driven through bureaucratic pressure - first from an independent inquiry (the HIH Royal Commission), second from the association of Australian supervisors, and third from an association of global regulators.

Yet the final shape of the deposit guarantee did not reflect that proposed by these independent bureaucratic actors. The concern of the Council of Financial Regulators was to draw strict lines around what funds were guaranteed and what funds were not. Swan accepted their recommendations when he announced in June 2008 that the financial claims scheme would cover depositors’ funds up to $20,000. Given that the status quo implied an unlimited guarantee of depositors’ funds, this was in fact a substantial reduction in the scale of the guarantee (Colebatch 2008; Davis 2008). However, in the first
half of October 2008, the government was faced with rumours of depositors removing their funds from
banks and was being lobbied by “the CEOs of major banks and top companies” to extend the explicit
guarantee (Swan 2014, p. 86). Taylor and Uren (2010, p. 57) write that the banks “cast aside” their
“longstanding concerns” about deposit insurance in the hour of crisis. Further pressure came from
Australian reports of increases in the deposit guarantee internationally, particularly in Ireland, the
United States, the United Kingdom, Greece, Germany and Denmark (O'Shaughnessy 2008; Shanahan
and Gluyas 2008). It was feared these changes would make it more difficult for Australian banks to
borrow in foreign markets. The opposition leader Malcolm Turnbull also proposed increasing the
guarantee cap from $20,000 to $100,000. The ultimate result of these pressures was a much larger and
explicit guarantee than had been proposed in June.

The final decision to introduce a bank deposit guarantee was made swiftly. Two days before the 12
October announcement, Rudd was publicly opposed to any change in the limits announced in June for
the Financial Claims Scheme (Shanahan and Gluyas 2008), although there had been discussions about
modifying the guarantee on 8 October (Taylor and Uren 2010). Swan in his memoirs refers to increasing
rumours of withdrawals “in the hours leading up to the announcement of the guarantee” (Swan 2014, p.
86). The final decision to extend the guarantee was made in a Cabinet meeting on 12 October and
announced on the same day. The announcement removed the $20,000 cap on the as-yet-unlegislated
financial claims scheme, and provided an unlimited guarantee. The guarantee was effective
immediately, and was intended to last for three years. A guarantee of wholesale funding was also
announced. APRA regulated ADIs (with the exception of foreign banks) were able to pay a fee in return
for a guarantee of their non-deposit debt obligations. This was intended to be a temporary measure,
“withdrawn once market conditions have normalised” (Rudd 2008). The unlimited guarantee for retail
deposits caused a run on non-eligible financial institutions – such as mortgage funds - as investors
moved to the new certainty of Australian banks (Williams et al. 2008). In response the Rudd government introduced a $1 million threshold above which funds would be guaranteed but would attract a fee for receiving such protection.

10.7 Conclusion
The Rudd government’s unlimited deposit guarantee in 2008 brought Australian prudential regulation full circle. With the 1945 Banking Act Ben Chifley introduced what the Labor government, the parliamentary Labor Party, and the Commonwealth Bank understood as an explicit guarantee of depositors’ funds in the circumstances where a bank unable to meet its obligations was taken over by the Commonwealth Bank. This policy was never tested. In the process of clarifying the ambiguities of the Banking Act when it was formalising prudential regulation after the introduction of foreign banks four decades later, the RBA read into the Banking Act a narrower scope than was intended by the Chifley government, characterising the RBA’s responsibility as to protect, but not guarantee, deposits. This formulation was however highly unstable. Australian depositors and banks looking for a continued implied deposit guarantee would not have to look far: indeed, beliefs with the Labor Party about the explicit guarantee are evident until the 1970s. The Victorian government’s bailout of the State Bank Victoria and the Commonwealth bailout of HIH brought demands for clarification about the scope of the implied guarantee. Policy authorities demanded clear rules on the circumstances and extent of the guarantee. Yet even the Financial Claims Scheme’s rules, developed in response to those demands, were overruled by the Rudd government in response to public demand and the lobbying of private banks.

Thus, in the light of the debate about bank guarantees between 1990 and 2008, we can return to the question of the “forgotten” bank guarantee. In the Niskanen (2008) model of bureaucratic incentives, bureaucracies and independent agencies seek to maximise their discretionary budgets. The 1945 legislation imposed a substantial liability on the Commonwealth Bank, which they objected to. However,
ambiguity in the legislation gave the central bank flexibility to reinterpret that legislation in its own favour. Whether deliberately or through a lack of institutional memory within the central bank, by the 1980s this reinterpretation was complete. The Commonwealth Bank/RBA had an incentive to avoid assuming responsibility for deposit liabilities. Indeed, it may well be that one of the reasons the deposit guarantee in the Banking Act was never tested was due to the central bank’s reluctance to take such responsibility. The RBA helped facilitate the 1979 Bank of Adelaide merger with the ANZ and the 1990 sale of the SBV to the Commonwealth Bank of Australia. Such negotiations helped prevent the RBA from assuming control of these banks – and therefore potentially assuming the liabilities – contrary to the original intention of the 1937 Royal Commission.

The place of the implied deposit guarantee between the Victorian government bailout of SBV depositors and the 2008 introduction of an explicit deposit guarantee can be seen as a tug-of-war between policymakers seeking to constrain the implied guarantee in order to prevent moral hazard and future instability, and policymakers looking to maximise the space in which they might act in support of depositors in the future. While the former group sought to establish firm rules on the circumstances in which governments would guarantee funds, the latter group sought discretion. For instance, the Wallis inquiry asked for a clear statement repudiating the implied guarantee, but the Howard government instead affirmed the implied guarantee. The Council of Financial Supervisors sought a strict rule-based guarantee with a low cap. This was announced in June 2008. Yet whatever constraints this rule offered were violated by the Rudd government just a few months later, as the $20,000 cap was abandoned to become an unlimited guarantee.

It was in the interest of the RBA to deny the existence of a guarantee in the 1980s for as long as that guarantee had little salience in the minds of banks and depositors. Yet the crisis of the 1990s – and the
implied relationship between government and depositors that crisis exposed – made the absence of this guarantee implausible. The Howard government rejected any constraint on discretion to deliver deposit protection to their supporters, a discretion which the government exploited after the collapse of HIH. Firms also benefited from the ambiguity of the deposit guarantee arrangements. An implied guarantee worked in the favour of the private banks, as it could be taken as an unlimited guarantee of all deposits.

How does the development of the safe haven idea and subsequent formalisation of the deposit guarantee fit this thesis’ models of political economy? The Diamond and Dybvig (1983) argument for deposit insurance is based on the inherent properties of banking contracts. Yet such public interest arguments had been rejected by a series of Australian government inquiries. When the HIH policyholder bailout occurred this appears to have convinced policymakers that the Wallis institutional structure could not prevent a discretionary bailout of depositors or policyholders in response to political demands. That realisation increased the perceived disorder costs of an implied guarantee, shifting the efficient point on the IPF to the right and to the establishment of a formal, but, critically, limited guarantee. Yet the Rudd government found itself as susceptible to the political pressures in the prospect of a bank run as the Howard government had been during the HIH collapse and the Cain government during the collapse of SBV. Bailouts constitute a transfer of wealth from taxpayers to depositors, policyholders and management. A private interest explanation for the financial crises of 1990 to 2008 emphasises the political and economic rents derived from the banker-populist coalition which ultimately gave Australia its formal deposit guarantee scheme.

Yet interest theories provide only a partial explanation for these changes. The Wallis inquiry struggled to reconcile its belief in market discipline and competitive neutrality with the established idea that depositors required a safe haven for their deposits that was effectively risk-free. The function of the
intensity of promise model was to integrate the safe haven doctrine into a prudential framework that
could simultaneously protect depositors from loss, allow the development of risky financial products,
and organise the regulatory framework on functional rather than institutional lines. The attempted
compromise position was unstable insofar as it was not robust to the political incentives faced by
policymakers at the time of the HIH collapse. The Conclusion of this thesis takes up this question about
the function of ideas as a constraint in determining the shape and position of the IPF.
11 CONCLUSION

11.1 Introduction
The history of prudential regulation in Australia can be divided into three phases. In the first phase, which lasted from Australia’s settlement to the Second World War, financial institutions were relatively unencumbered by prudential controls. Banks were either governed by companies law, charters, or their own incorporation acts. State control of banking was minimal and social control was imposed through market discipline. While the establishment of the Commonwealth Bank in 1911 modified the institutional landscape governing banking by offering a state-owned alternative to the private banking system, in its first three decades the Commonwealth Bank had little regulatory power, and exercised its influence on the economy through its role as government banker and (from 1924) control of the note issue. While a role as lender of last resort was arguably implied by the regular invocations of the Commonwealth Bank as a ‘central bank’, it imposed no prudential controls on the private banks. The market discipline approach, occasionally supplemented by ad hoc political interventions such as that which kept foreign banks from entering the Australian market in the interwar years, lasted in substance until heavy controls were imposed under national security regulations in the Second World War.

The second phase was defined by the provisions of the Banking Act 1945, which imposed social control on banking through heavy regulation. Prudential control was not a primary focus of the Banking Act, nor that of the 1937 Royal Commission into Monetary and Banking Systems which conceived of much of the provisions of the legislation a decade later. Nevertheless, the Banking Act established the regulatory framework whereby prudential control was handed to the Commonwealth Bank (and later the RBA) which had a special responsibility for the protection of bank depositors. The 1937 Royal Commission had conceived of the Commonwealth Bank’s prudential responsibility as ensuring the stability of the banking system. However, as this thesis has shown, when the Banking Act was introduced, the Curtin
government reconceived this prudential responsibility as to protect the depositors of the banks themselves. By doing so, they believed they were establishing a bank deposit guarantee which would apply when failed banks were taken over by the Commonwealth Bank. Between 1945 and late 1970s, prudential control was exercised through regulation of bank products, and cooperative supervisory arrangements that relied on the close relationship between the central bank and regulated banks.

The third phase is that commonly described as the “deregulation” phase, sparked by the Campbell committee and the Hawke government’s upheaval of the Australian financial system. Momentum for regulatory reform was driven by events outside the regulated banking sector. The first of these was the capture of market share from banks by NBFIs that were regulated by state authorities. Pressure came from the banks themselves, who sought either the regulation of NBFIs comparable to that imposed by the Banking Act or, alternatively, a reduction in the controls on banks, and the newly opened window of institutional possibility offered by the High Court’s Concrete Pipes decision. When the Fraser government came to consider the Whitlam government’s subsequent Financial Corporations Act, it made the decision to pursue regulatory reform by favouring social control through market discipline rather than increased government control. The Hawke government followed this approach, which represented a significant change in the Labor Party’s ideas about banking.

However, the move towards market discipline was not absolute. The third phrase of prudential regulation in Australia constituted not deregulation but regulatory formalisation and growth. The Campbell committee’s approach to prudential regulation was a stark contrast to its policy approach elsewhere. Rather than favouring market discipline it proposed a rationalisation and clarification of regulatory control. The increased cost of supervising an enlarged banking sector after the introduction of foreign banks in 1985 necessitated the formalisation of prudential rules, changes to surveillance and
supervisory practices, and new rules in areas such as capital adequacy and liquidity management. The demand for formalisation and regulatory expansion explain Australia’s rapid adoption of the Basel Capital Accords, which provided an off the shelf capital adequacy framework shared by Australia’s trading partners. The process of regulatory formalisation meant that some regulatory controls were reconceptualised as prudential regulation. One such instance was the bank ownership limits brought in to prevent foreign investment in banking. Likewise, the Four Pillars policy, whose original purpose was to satisfy populist concerns about the power of banks and maintain the competitiveness of the Commonwealth Bank of Australia in the lead-up to its privatisation, evolved to be seen as a prudential control.

The instability and weakness of the prudential framework established in this third phase was made clear during the three financial crises between 1990 and 2008: the Victorian crisis of 1990, the collapse of HIH Insurance in 2001 and the GFC in 2008. An attempt to define and constrain the responsibility of prudential regulators to depositors in the Wallis inquiry failed with the HIH bailout. Policymakers and advisors then reassessed their views about the desirability of a deposit guarantee in the light of the political incentives to support depositors. A further attempt to limit the scope of this deposit guarantee was abandoned at the start of the GFC. Tying these deliberations together was the principle that depositors required a safe haven for their deposits, and events demonstrated the fundamental tension between that principle and the market discipline approach to social control of banking that had been urged since the Campbell committee.

11.2 Results

11.2.1 Question 1: characterising regulatory institutions

With this narrative of regulatory change in mind, we are in a position to answer the questions posed at the start of this thesis. First, how have the institutions of prudential regulation changed during the
period covered by this thesis? Using the Djankov et al. (2003) institutional possibility frontier, it is possible to characterize regulatory institutions with greater clarity and confidence than has been previously provided by the literature and popular understanding of patterns of political economy. In the first phase, social control was exercised through market discipline. This does not imply that the point on the IPF chosen by colonial and Australian governments was efficient in any normative sense, but rather reflected the confluence of political factors and institutional factors, as well as the limited number of alternative modes of control. In the second phase, social control was exercised through the regulatory powers vested in the Commonwealth Bank and RBA. While the Commonwealth government was constrained by constitutional limits on the regulation of NBFIs, similar social control was exercised by the state governments on NBFIs, although relative differences between the two regimes significantly shaped the Australian financial sector.

While the application of the IPF to the history of regulatory change is novel, these characterisations are not controversial. Where this thesis departs from the literature is in its characterization of the third phase. Rather than being characterized as a period of deregulation, where social control moved towards the market discipline end of the IPF, the area of prudential regulation saw a formalization, expansion, and internationalisation of regulatory control. The approach to regulation taken by the Australian government in the third phase was substantially different to that taken by the second phase. While it might be argued that more formal rules governing prudential standards reduced the dictatorship costs of regulation that could be brought by discretionary and potentially privately interested regulation, the increased intensity of regulatory control, the tighter strictures placed on capital adequacy and more formal surveillance lead us to conclude that the third phrase represented a shift to the right on the IPF. In other words, social control was exercised more through government power after the ‘deregulation’ of the 1980s than before. The cooperative regulatory arrangements of the second phase were as
vulnerable to disorder costs – through the failure of the Commonwealth Bank and RBA to monitor and identify risks – as they were to dictatorship costs. The formalisation of regulation after the introduction of foreign banks resulted in a more rigid and intrusive mechanism of control.

11.2.2 Question 2: explaining regulatory change

The second question asked by this thesis is: what were the political, economic, and ideological drivers of prudential regulatory change? This thesis started with a modification of the typology of regulatory change conceived by Kroszner (1999), dividing the dominant explanations for regulatory change into public interest explanations, private interest explanations, and explanations about changing ideas or ideologies. There is more than enough evidence within the history of Australian banking regulation of privately interested reform. Two of the most striking are the restrictions on bank entry – both informal before the Second World War, and formally under the Banking Act – which delivered economic rents to incumbent banks, and the rents delivered to the government through the captive market asset requirements. Under the Curtin government’s deposit guarantee scheme, depositor protection was exchanged for control over lending to favoured political constituents, as the Calomiris and Haber (2014) model predicts.

Public interest models, by contrast, ground their positive accounts of regulatory change in the search for institutional efficiency. Publicly interested policymakers will vary their institutional choice according to exogenous changes in the characteristics of an industry, including its structure, technological and entrepreneurial change. Public interested regulatory change is primarily a normative model, but as Kroszner (1999) points out, it is often applied to changes in financial regulation, particularly the regulatory reforms that followed the economic turmoil of the 1970s. Assessing the public interest model in the long run of regulatory change gives it more plausibility than it otherwise appears on its face. For
example, while the 1937 Royal Commission created a regulatory system whereby private interests could extract rents through barriers to entry, it is not incontestable that this was driven by regulatory capture. The Royal Commission heard extensive evidence from private banks who urged the government to restrict entry, yet when it came to the implementation of those recommendations by the Curtin government in 1945, their hostility to the private banks meant that they neither consulted the banks nor had any intention of enriching them through protection. An alternative explanation grounded in public interest models leads us to emphasise that both the economics profession and policymaker community saw licensing and entry restrictions as the correct normative approach to banking regulation.

This emphasises the need to see ideas as a dynamic factor shaping both positive private interest and public interest models. Public interest models are not only constrained by the civic capital in the Djankov et al. (2003) IPF but social ideas about the role, purpose and possibilities of institutions, the availability of institutional choices, and beliefs about the function of the affected industry in the prevailing political and economic landscape. This can be formalised by modifying the IPF to focus not on disorder and dictatorship costs, but on the individual subjectivity of disorder and dictatorship costs. The history of Australian financial regulatory change can be mapped through changes in perceptions of the costs of disorder and dictatorship. Furthermore, there are transactions costs governing the transmission of ideas, and policymakers are constrained by the suite of institutions on the IPF available at any given time.

How did this work in practice? The crisis of 1893 increased the perceived disorder costs of market discipline, leading to pressure for regulatory reform. However the institutions of social control were for the most part in this period limited to a choice between market discipline and nationalisation, each favoured by different segments of the political population. This compromise position was the creation of
the Commonwealth Bank as a competitor to, rather than regulator of, the private banks. New ideas about the possibility of formal banking regulation were given political salience during the Great Depression – despite the relative resilience of the Australian banking sector in that period – and ideological changes reduced the perceived dictatorship costs of banking regulation. Those ideas gave nationalisation a further plausibility, leading to the Chifley government’s 1947 attempt to nationalise the private banks, which was contested by those for whom the perceived dictatorship costs of nationalisation were unacceptably high.

Ideas about subjective disorder and dictatorship costs offer even more fruitful explanations for regulatory reform in the “deregulatory” period. After two decades of financial repression under the Banking Act, the perceived dictatorship costs of non-market control and the schism between banks and NBFIs led to regulatory reform first under the Whitlam government and then the Fraser government. It is correct to say, as Kroszner (1999) does, that ideological factors were central to financial deregulation but the influence of ideology might better be seen as a historical constant. Ideology is better conceived as relative ideas about the perceived costs of dictatorship and disorder. After the introduction of foreign banks, perceived disorder costs of cooperative regulation led to more intensive regulatory control, involving not only the formalisation of regulation in Australia but the expansion of the regulatory jurisdiction globally, particularly in the wake of the Bankhaus Herstatt crisis and the Mexican bailout. Perceived disorder costs of unencumbered bank mergers and discretionary deposit guarantees led shifts on the IPF in 1990 and 2008 respectively.

11.2.3 Question 3: changing justifications for regulation

Finally, this thesis asks: how have the justifications for prudential regulation and the mechanisms by which regulation is implemented have varied in response to, and been dependent upon, these drivers?
Institutional choices are sticky, in that the decision to adopt a given institution is partially determinative of the scope and possibilities of institutional choices in the future. Private interest models emphasise that institutional choices are made in order to deliver rents to private interests, and those interests have a stake in ensuring that those rents continue to be delivered or that they are compensated for reductions in those rents. The existence of those interests increases the costs of institutional change. A similar path dependency in institutional choice is driven by the longevity of ideas. Perceived disorder or dictatorship costs – such as the disorder costs embodied in the Money Power, or the dictatorship costs embodied in the critique of financial repression in the 1970s – exhibit an influence long after their first conception or the events that sparked their development. Money Power rhetoric may have ebbed by the time of the Banking Act 1945 but the attitudes to banking embodied in the intellectual environment after the 1893 crash remained. Likewise, the Campbell committee’s conception of a market-based banking sector buttressed by prudential controls was the same idea that drove subsequent inquiries. The most significant sticky idea was the idea that the government needed to ensure depositors had a safe haven for their deposits, an idea which had its germ in the wake of 1893, was given formal recognition in 1945, and which was threaded, both explicitly and implicitly, through the reviews and policy decisions of the 1970s to the 2000s. That the economic and intellectual foundations of this idea were never fully articulated, let alone challenged – despite the many opportunities to do so – suggests the centrality of ideas to path dependency.

Finally, institutional choice can be sticky even when the original purpose of a given institution is anachronistic. This thesis has shown how the justifications for institutions have evolved according to changes in ideas about regulation while the institutions themselves have been fixed. Bank ownership limits and the Four Pillars policy have already been mentioned, but it is also noteworthy how the LGS and SRDs, originally mechanisms of monetary control, were reconceived as prudential controls and
reconstituted as the PAR and NCDs. It is less costly to repurpose an existing institution to satisfy the
demands of changed ideas than to create new institutions, and more likely to satisfy the incumbent
private interests that either rely on them for rents or have arbitrated around those institutions.

11.3 Limitations
This thesis has offered an account of changes to prudential control of banking by focusing on the specific
political and economic events through which those changes were made. It has sought to identify the
origins of those decisions as a window that might suggest motivation. Fine grained historical analysis has
provided a basis on which the applicability of models of regulatory change can be judged. However, this
approach has some limitations. Cause and effect can only be suppositions derived from the available
evidence. The better the documentary sources the more confidence we can have that those judgments
are reasonable. We cannot be sure why, for instance, the Curtin government failed to clarify the scope
of the deposit guarantee that they told Cabinet, the Commonwealth Bank, and Labor parliamentarians
informed the legislature they intended to introduce. More comprehensive documentary evidence if
found might shed further light on these decisions, and subject the results of this thesis to revision.
However, as with any historical investigation, even the best attested conclusions are contestable.

Finally, the thesis has not attempted to quantify the breadth or extent of regulatory controls. One
approach might be to estimate the welfare losses during each of the three phases due to regulatory
controls. Another approach might be to look at the volume of legislation and subordinate legislation
affecting the financial sector, assessed by pages, word counts, or some other measure. This would
constitute a sectoral focus for the approach taken in Berg (2008) and Novak (2013). A further alternative
approach might be to adopt the Mercatus Center’s RegData system for Australian banking regulation.
RegData has the ability to compare legislation and regulation based on the content of the text, including
the number of restrictions and commands like “shall” and “must” (Al-Ubaydli and McLaughlin 2015). The
author is aware of a project to introduce RegData for Australian legislation, and this might offer a fruitful future approach, particularly if historical legislation and regulation is made available. Nevertheless, these approaches have their own limits. Welfare loss estimates tell us little about why regulatory change occurred. Quantitative assessments of the volume of legislation tells us little about the content and severity of legislative control. And focusing on black letter law regulatory controls downplays the significance of the cooperative regulatory approaches which characterized prudential regulatory approaches for half a century after the Banking Act.

**11.5 Further study**

These limitations suggest at opportunities for further study. It may be possible, using RegData or similar approaches, to produce quantitative analyses of regulatory regimes. With such work we would be able to more accurately characterize changes in those regimes. Likewise, extra documentary evidence will be available as Cabinet documents are released. The research process for this thesis has reveals some other opportunities for future scholarship. For example, Chapter 8 offered a first pass at accounting for Australia’s involvement with the Basel Capital Accords but there is much opportunity to deepen our knowledge, not only of those events but of the significance of regulatory internationalisation for the Australian economy. This is particularly the case given Australia’s involvement with global regulatory agreements across a wide range of policy areas from trade to greenhouse gas emissions reduction policy. Another fruitful area of analysis might be the dramatic change in policy from the Wallis inquiry, which rejected explicitly a deposit guarantee, to the moves of the Howard government just a few years later to introduce one. The effect of the political decision to bailout HIH Insurance policyholders is a key moment in the political economy of banking, and deserves more of a place in the literature than it has received.
One particular finding that needs to be incorporated in the history of Australian banking and economic policy is the existence of the explicit bank deposit guarantee in 1945 along with its subsequent disappearance. The deposit guarantee was a critical part of the Chifley government’s social reform program, demonstrating that the 1945 legislative program was not merely concerned with macroeconomic policy through the banking legislation and the White Paper on Full Employment, but with the guarantee of small depositors, offering a link between the 1893 crash and the Curtin-Chifley government. Memory of this guarantee lasted well into the 1970s. It provides a partial explanation for the inability of the RBA to erase popular beliefs in the existence of the deposit guarantee. Furthermore, it complicates scholarship, such as that based on Demirgüç-Kunt, Karacaovali and Laeven (2005) that had assumed Australia had a solely implicit guarantee. To what extent did the ambiguity in the legislation and the uncertainty of the banking guarantees status effect the incentives and risk taking of banks after 1945?

11.4 Implications of the research
The origins and causes of regulatory change in Australian history are of more than historical or academic interest. The last few years have seen a stream of popular commentary that has complained of the end of the era of economic reform. For instance, an influential analysis by Kelly (2014, p. 69) argues that Australia now suffers from “a new political culture shaped by reform timidity, the power of negative politics and a recognition that long-run reform faced Herculean obstacles from a new regime of short-run, sectional-interest, media-driven tyrannies.” These complaints are not new. Garnaut (2005) spoke of the “Great Complacency”. Hyde (2001) argues that reform fatigue set in after the defeat of the John Hewson opposition and its Fightback! policy agenda.

However, by looking at how the regulatory reform program was first sparked we can better understand the constraints surrounding future reform, and the policy and economic factors which drive change.
Regulatory change does not materialize out of nowhere. The political circumstances that demanded the Fraser government choose between the two possible institutional approaches to financial markets – the further regulatory control of the Whitlam government’s Financial Corporations Act or a new ‘private enterprise’ approach – was created by changing ideas about the governance of the economy and a pressing economic crisis. The 1945 Banking Act was the result of a clash of ideas about the control of the banking sector, with Labor’s Money Power ideas and the interest of Country Party members in heterodox banking theory on the one side, and the United Australia Party’s desire to maintain the existing system on the other. Throughout the period under study, it is clear that crises have driven regulatory change, even if that change has a lag of even decades: policy to prevent the trauma of 1893 was only introduced in 1945, but the development of the Money Power ideas and prudential regulation are the link between the two events. Reform is not the result of autonomous government decisions, but the result of a confluence of short term political factors, and changes in the perceptions of the dictatorship or disorder costs of the status quo and alternatives.

The analysis provided by this thesis is itself part of that reform process. Positive accounts of past changes ought to inform normative models. To start, it is essential to accurately characterise where a given industry is on the IPF in order to identify alternative institutions of social control. Popular beliefs that the 1980s was an era of ‘deregulation’ for banking are not accurate, at least in the realm of prudential regulation. Given that this thesis has identified the perception of disorder and dictatorship costs as a pivotal factor underpinning regulatory change, mischaracterisations of regulatory regimes can have practical consequences. More fundamentally, an understanding of the process of regulatory change is an essential part of the creation of ‘robustness’ in political economy. Constitutional-level analyses look at the incentive structures faced by political and economic actors. Understanding how
those actors respond to incentives, and how they have responded to exogenous events under
constitutional constraints, provides vital information for the future development of robust policymaking.
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