
WALLIS INQUIRY — COMMERCIAL IMPLICATIONS FOR FINANCIAL SERVICE PROVIDERS

GAVIN WALKER

**Head of Investment Bank
Bankers Trust Australia Limited, Sydney**

It is all too easy, in discussions about the Wallis Report, to slip into bland generalities about the nature and impact of the great themes dealt with by the Financial System Inquiry. Terms such as globalisation, technological innovation, and regulation lose their impact when divorced from the reality of the marketplace in which they are wreaking so much change.

Today I want to re-inject a sense of marketplace reality into the discussions of the Wallis Report – to portray the issues as they appear from the point of view of an Investment Bank which is dealing with them on a daily basis.

In doing so I want to make some specific comments about three aspects of the Wallis Report debate. I have little patience with the commentators who have seen the Wallis Report solely through the limited prism provided by their preoccupation with Big Bank mergers. Important as that issue is, it is far from the only one or even the most important one. My comments will focus on:

- one, the Wallis discussion on globalisation;
- two, its recommendations on regulatory reform, which I believe the Committee has failed to argue adequately; and
- three, the issue of taxation reform, which it was prevented by its terms of reference from arguing at all.

Anyone reading the financial press with even half an eye would have been struck by the dramatic headlines announcing change in investment banking around the world in recent years.

These include:

- the rush of major European banks to add Investment Banking arms; only last week SBC Warburg announced a USD600 million deal to buy the Wall Street Investment Bank Dillon Read;
- the moves by US Investment Banks into Fund Management and in some cases Banking as the grip of the Glass Steagal Act is gradually loosened; most notable in this regard is Morgan Stanley's acquisition of Dean Witter;
- the spectacular blow-ups of which Barings and Sumitomo are only the best reported.

Behind these headlines lie several interwoven elements in the story of how international Investment Banking is unfolding.

- In Europe, the major banks have assessed the implications of the integrated European market as likely to cause their traditional sources of profit to slide; as a consequence they studied the success of Investment Banks in the US, and got out their cheque books.
- At the same time, that is over the past decade or so, the US pension funds have increasingly been investing offshore. They no longer ask the question: "If we are investing in textiles, which are the best textile companies in the US for us?". Their focus embraces the NAFTA economies, the Asian tigers and other emerging economies in Asia, eastern Europe and elsewhere.
- Meanwhile, individual companies in an ever-increasing range of industries are competing internationally and globally, and if they are seeking finance from international markets, they need Investment Bankers – advisers, researchers, financiers – who know the industry world wide.
- So there are forces for change on both the buy and sell sides – the demand for and supply of investment grade paper.
- And the product "investment grade paper" itself is no longer so simple to define either, as products and markets move through their life cycles. In the fixed interest markets, we have seen the evolution of a whole web of instruments emerging from the basic "plain vanilla" Commonwealth Federal bond: State Government bonds, fixed and then floating rate securities, CPI bonds, mortgage securitisation and infrastructure bonds. Of course this evolution has significant impacts on revenue sources for Investment Banks.

In Australia, financial deregulation through the 1980s and early 1990s, alongside the maturing and sophistication of the marketplace, means that these global trends have had full play in our marketplace.

- Anyone questioning whether the process of change has not yet been unleashed in the Australian investment banking industry need only consider the fate of Australian equity broking. A very few years ago, this industry featured names that were part of the historical fabric of Australian stockbroking and the business community. Today, eight of the Top 10 equity brokers in Australia are foreign owned. Macintosh was recently acquired by Merrills, Bains by Deutsche Morgan Grenfell and Ord Minnett by Jardine Fleming. Only Macquarie and JB Were remain independently owned.
- The arrival of foreign players has had the effect of creating – through the fortuitous outcome in some cases of acquisition decisions made overseas – strong widely based institutions which have immeasurably strengthened domestic competition across the board – at the big end of corporate finance, investment management, and in securities trading and research.
- The dynamics of globalisation are also highlighted by a glance at the names on the Telstra tombstone. The float involves:
 - an Australian retail distribution capability through JB Were;
 - a European distribution capability through ABN Amro;
 - US institutional distribution capability through CS First Boston.

In other words, local expertise and familiarity with the Australian market, counts for only a local niche role; the global roles are filled by institutions chosen on the basis of global distribution and their knowledge of, in this case, global telecommunications industry.

So, globalisation is not just a catch phrase – it is a fact of life.

And the hard fact of life is that it is easier for a global institution to acquire expertise in the Australian marketplace than for an Australian institution to acquire global strengths.

At the same time, domestic Australian clients will increasingly prefer Investment Banks who can offer global understanding of their increasingly global business, over those whose horizons are purely local.

All this of course marks the success of the deregulatory process. The upshot is clear: to be a competitive investment banking institution in the Australian marketplace, an investment bank will need:

- product compatibility on a global basis;
- research capability on a global basis; and
- global distribution.

Of course, not all deals will be done by global institutions. There will be niche players in local markets. Macquarie Bank's strength in the Australian infrastructure/privatisation process is a case in point.

But it is my conviction that – as the list of equity brokers suggests – in the Australian marketplace the day of the independent financial institution is all but gone.

So, we agree with the Wallis Committee's description of the forces shaping the future environment.

We live with the commercial realities of these developments each day.

This is not the place for me to set out Bankers Trust's strategy for building on our present strengths and benefiting from the new world. However, a couple of brief comments will indicate the extent of adaptation taking place.

- Our US parent Bankers Trust Company which, incidentally, now earns 50 per cent of its income outside the US, has during the last twelve months acquired the M&A firm Wolfensohn to strengthen its corporate advisory capabilities, and Alex Brown, a broking house with expertise in IPO's and a strong research base.
- Here in Sydney, the twin franchises of Bankers Trust Australia – Investment Banking and Funds Management – are becoming members of this global trend by taking responsibility for a number of significant new regional and global opportunities within Bankers Trust Company.
- My colleague Ian Martin, Head of BT Funds Management, has taken on responsibility for BT's Fund Management operations worldwide – globalisation driven from Australia. The Funds Management business is also growing a number of joint ventures in South east Asia.
- Similarly, in the Investment Bank which I head, Jillian Broadbent has taken on responsibility for the management, again out of Sydney, of BT's global metals and mining business, while our foreign exchange head, Ivan Ritossa, is now based in Singapore and manages BTCo's regional FX effort.
- For my own part, since I was appointed Head of the Bankers Trust Investment Bank last October, I have made it very clear that we must change the way we do business. Traditionally BT was regarded as having strong transactional expertise and for driving its

business from a product focus. It was a strategy that served us well – but in the contemporary climate, reliance on those skills alone will be a formula for failure.

- Why? For many of the reasons I have already alluded to. A lot of the products and skills we pioneered have been emulated and “commoditised” in this more competitive, global marketplace. And our clients, rightly, demand more. They want long-term solutions to their financial needs: a full-service approach that recognises and addresses the complexity of their underlying needs, which are increasingly global in nature.
- So to meet the demands of a more competitive marketplace today, we are restructuring to eliminate the old business lines – the Financial Markets group, Equities group and the Corporate Finance group – to create a single integrated structure which can offer clients a dedicated service from across all our capabilities.
- We are making sure that when our customers come to us with a complex problem, they will get the best answer that spans the whole spectrum of our skills, at the intersection of debt and equity and advice and risk management, and incorporating the best ideas from around the world.
- Investment Banks unable to offer this degree of service in the Australian marketplace will wither.

I hope I have made it clear that I have little complacency about the future for the Investment Banking Industry in Australia. We are facing as an industry strong competitive pressure which will inevitably lead to a shake-out. The best news is that from the point of view of the client, service will continue to improve and costs will decline.

In short, the forces described in the Wallis Report in general terms are very real.

I turn now to the recommendations that the Wallis Committee made for regulation to deal with this rapidly changing world.

One of the dangers of Committees of Inquiry is that they will make too many recommendations for change. The Wallis Inquiry is to be congratulated for what is, on the whole, a measured assessment of, and response to, the forces driving change.

- We did not need a revolution, and they have not recommended one.
- We did not need a long list of populist or politically correct recommendations, and we did not get that.

In several areas the Committee resisted pressure for recommendations in favour of additional regulation. In regard to Investment Banking they have recommended against further regulation of Over the Counter products such as derivatives.

At BT we saw the Inquiry as representing a great opportunity to achieve a rational basis for regulatory supervision for the entire spectrum of financial products. As we put it in our submission, where an investment is market linked, we believed that a disclosure regime should be adopted; and where an investment is balance sheet dependent, a prudential regime is more appropriate.

In the funds management area as well, the recommendations of the Committee should result in less duplication and more straight forward and effective regulation.

So, there are many recommendations in the Report which are sensible, and which if accepted will improve the efficiency of the markets.

The most controversial recommendation of the Report is that in favour of a new, single prudential authority, separate from the Reserve Bank, but with the Reserve Bank retaining responsibility for avoiding or dealing with systemic risk.

Frankly, I remain unconvinced of the wisdom of this recommendation for several reasons:

- First, the existing arrangement has, by luck or good management, avoided systemic problems since the creation of the Reserve Bank. If we are to reach a conclusion that such a model is outdated, I would like to have seen more analysis as to why this is so. Matters on this issue which need further consideration are:
 - what are the implications of new technologies for systemic risks?
 - what are the implications of the proposed Real Time Gross Settlements system?
 - are the most likely sources of disturbances local or overseas?
 - how would the RBA and the proposed APRC in practice work together in a crisis situation?

The Report is very brief on these issues.

- Second, one of the reasons the Committee recommended that the single prudential regulator be separated from the RBA was to make clearer that there is no Government guarantee of bank deposits. However, it may be impossible politically to lessen the degree of guarantee which currently, in reality, exists. If that is so, the benefits of having a single regulator will be lost by the proposal for separation.
- Thirdly, and most importantly, there is the issue of which structure is likely to give the best "culture" to the regulator. If we must have regulation, it should be consistent with ensuring effective prudential control, is "outcome" and "efficiency" oriented and avoids becoming "rules based only".
- The RBA, with its broader economic responsibilities, would be more effective in achieving this than the "independent Boards" mechanism proposed by the Wallis Committee for the separate regulator.

Looking ahead, whatever the post-Wallis regulatory structure is there could be further impacts for Investment Banking, from changes to capital requirements to other regulations as the new regulator strives for more seamless and consistent regulation.

What are the implications of this? Will for example differing capital requirements force various activities into subsidiaries under a holding company structure?

Will a bank licence still be valuable to an Investment Bank in Australia?

Such changes may be years away, and hopefully in line with recent practice, there will be a consultative and evolutionary process.

Finally, let me turn to a consideration of the issue which Wallis was unable to address – the crucial issue of taxation.

One of the enduring failures of this Financial System Inquiry was that the terms of reference did not allow the Committee to address the implications the taxation system has on the Australian financial system. This failure represents a lost opportunity.

The financial sector is afflicted with a rag bag of taxes imposed by both Commonwealth and State jurisdictions without having any consideration of their impacts on financial markets. Each tax creating its own cost distortions and carrying its own compliance complexities, often on a

State by State basis. The list is no doubt familiar to you: FID, BAD, FIF, FBT, withholding taxes, stamp duties and the idiosyncrasies of the Income Tax Act itself.

Faced with such an array, it is no wonder that when international financial houses consider where their Asian operations should be based, they increasingly look elsewhere.

It is not my purpose to argue the merits or demerits of particular taxes.

It is, however, my purpose to express deep concern about the *process* by which taxation reform currently takes place in Australia.

- It is a process that lacks transparency; there is no clear strategy or direction to tax reform.
- It is a process that asserts an anti-avoidance, pro-revenue motives but hits legitimate business activity very severely.
- It is fragmented and piecemeal; ad hoc; all about stop-gap incrementalism.

If all this was true before the Wallis Inquiry was established, it is even more true now, in the wake of this month's Budget.

The Treasurer's Press Release "Measures to Prevent Trading in Franking Credits" asserted an anti-avoidance purpose which if properly implemented would have raised no wider problems. In fact however the decisions announced have thrown into question a number of legitimate risk management practices and products. What it has done is to discourage hedging of equity derivative products and therefore has reduced liquidity in this market for users. It also introduces tax into the pricing equation where it did not exist previously.

So it is nothing short of a lost opportunity that Wallis was precluded from commenting on taxation – the area in need of greatest reform.

The sooner this issue is addressed the better.

In that regard, I note that Wallis recommended the establishment of a Financial Sector Advisory Council, to provide private sector expertise to the Treasurer on a range of issues including "the cost effectiveness and relevance of regulation of the financial system".

I urge this Council be established quickly and that it be given an explicit and expanded mandate to undertake, as its first item of business, a stock take of taxation policies in the financial sector and the development of orderly procedures for formulation of taxation reforms for the financial system.

Certainly, the claims of this city to being a regional financial centre would be enhanced by an orderly and considered process of taxation reform in the financial industry.

In summary, the picture that the Wallis Report painted of the forces shaping developments in the financial markets is very real and cannot be dismissed.

The recommendations for change are, on the whole, measured and well aimed at improving the efficiency of the markets.

I have mentioned one area where I have a difference of view as to how to get the most productive culture in a prudential regulator.

But the overall impression I have of the Inquiry exercise is one of lost opportunity because the Committee was precluded from making recommendations on tax reform.