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BACKGROUND PAPER FSL5

LEGISLATIVE FRAMEWORK FOR CORPORATIONS AND FINANCIAL SERVICES REGULATION

Risk and Reform in Australian Financial Services Law

March 2022

This discussion of the role of risk in reform of Australian financial services law is the fifth in a series of background papers to be released by the Australian Law Reform Commission as part of its Review of the Legislative Framework for Corporations and Financial Services Regulation ('the Inquiry').

These background papers are intended to provide a high-level overview of topics of relevance to the Inquiry. Further background papers will be released throughout the duration of the Inquiry, addressing key principles and areas of research that underpin the development of recommendations.

The ALRC is required to publish three Interim Reports during the Inquiry, and these Reports will include specific questions and proposals for public comment. A formal call for submissions will be made on the release of each Interim Report. In the meantime, feedback on the background papers is welcome at any time by email to financial.services@alrc.gov.au.

The Australian Law Reform Commission (ALRC) was established on 1 January 1975 and operates in accordance with the *Australian Law Reform Commission Act 1996* (Cth).

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Introduction

1. The concept of risk occupies a central position in societies, economies, financial systems, and markets, as well as in financial regulation and regulation more broadly. Taking risks and managing risks is a part of human existence: and as Bernstein notes, advances in our 'capacity to manage risk, and with it the appetite to take risk and make forward-looking choices, are key elements of the energy that drives the economic system forward'.[1] In particular, present in much thinking about risk is the trade-off between risk and return. In financial markets, a greater willingness to bear risks is often associated with the potential for larger rewards.

2. This Background Paper examines changing approaches to risk in Australian financial services regulation and the extent to which regulation has not adapted to take account of these new approaches. Chapter 7 of the *Corporations Act 2001* (Cth) ('*Corporations Act*'), and other financial services laws, offer a tapestry that tell the story of how different regulatory approaches to risk have evolved over the past twenty years.

3. The Paper suggests that this tapestry, and the regulatory philosophies that have woven it, have evolved in response to new understandings of risk: how and to what extent regulators should manage it; how consumers understand it; and the increasing extent to which consumers are exposed to it. Behavioural economics, financialisation, the 'risk-shift' to individuals in areas such as superannuation, and international developments such as the Global Financial Crisis, have all informed new understandings of and approaches to risk. In particular, this Paper considers how shifting approaches to product risks, conduct risks, and institutional and systemic risks, have shaped Australian financial regulation.

The key finding: the legislative architecture matters

4. The central finding of the Paper is that the legislative architecture for regulating product risks and conduct risks in financial services legislation has struggled to adapt to, and facilitate, changes in regulatory philosophies. As Parts Two (product risks) and Three (conduct risks) demonstrate, disclosure- and conduct-focused financial services legislation has been subject to dramatic reform over the past thirty years. These have often been driven by efforts to implement shifting regulatory philosophies, notably towards risk.

5. As the history of changing approaches to product and conduct risks illustrates, financial services regulation in Chapter 7 of the *Corporations Act* lacks an architecture that can adapt to and support changes in regulatory philosophies without generating significant complexity. Instead, reform of financial services law (particularly Chapter 7) has occurred through a complex mix of exemptions, conditions, notional amendments, obligations, and prohibitions, contained in regulations, ASIC or ministerial legislative instruments, as well as amendments to the *Corporations Act* itself. This has been driven, in large part, by the inconsistent legislative hierarchy in Chapter 7, which, for example, sees both principled and prescriptive obligations across various types of legislation: in the Act, regulations, and hundreds of ASIC instruments. Regulatory philosophies have been built upon one another through new initiatives, usually without much change to the law that came before. More interventionist philosophies towards risk, manifested in laws such as those regulating responsible lending, MySuper, or design and distribution obligations, have simply been built atop the pre-existing disclosure-focused architecture. Duplication and redundancy are by-products of the ad-hoc way in which the existing law has developed.

6. The Chapter 7 reform process can be contrasted with the way in which reforms concerning institutional and systemic risks have been incorporated in legislation administered by the Australian Prudential Regulation Authority ('APRA'). As Part Four of the Paper shows, prudential regulation

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1 Peter L Bernstein, *Against the Gods* (John Wiley & Sons, 1998) 3.

has also seen significant changes in regulatory philosophies towards risk. The framework for regulating those risks, however, is embedded in legislation that can support evolving regulatory philosophies without the degree of complexity seen in Chapter 7. The framework is underpinned by a clear legislative hierarchy and functionally focused Acts for different activities (such as life insurance and banking). Acts establish the regulatory architecture, covering higher-level topics such as the establishment of prudentially-regulated institutions and the powers of APRA. Acts empower APRA to make prudential and reporting standards (as legislative instruments) that cover the detailed obligations to which an entity is subject and which can evolve as needed, often following long periods of highly technical consultation. This legislative framework creates a clear allocation of responsibilities between Parliament, the Treasury, ministers, and APRA, which has proven important in reforms to prudential regulation. Unlike Chapter 7 of the *Corporations Act*, where there are overlapping responsibilities in many areas, the clear allocation of responsibilities has minimised duplication and complexity. Whether or not one agrees with the particular design choices underlying the APRA model of regulation, it has the key attribute of consistency: a regulated entity generally knows who will make the rules that affect it, the manner in which they will be made, and where those rules are located.

Policy and legislative complexity

7. The architecture of Chapter 7 of the *Corporations Act* has struggled to adapt to new policy positions rooted in shifting regulatory philosophies. However, as the accretion of law over the past twenty years illustrates, this Paper finds that policymakers have rarely been willing to undertake the difficult task of reviewing and revising earlier policies and regulatory philosophies. Instead, new law has been built upon the old. This has been a significant source of legislative complexity — and one which, under the current legislative architecture, drafters alone can do little to reduce.

8. For example, despite an increasing shift away from disclosure as the foundational regulatory tool, the vast majority of disclosure-related law remains unchanged. The continuing footprint of disclosure-related law in the *Corporations Act*, regulations, and ASIC legislative instruments, testifies to the reluctance of policymakers to review and simplify the fundamentals of existing legislation. This is despite disclosure having arguably been displaced or made less central by more interventionist policies, such as design and distribution obligations, bans on conflicted remuneration, and product intervention powers. The role of disclosure is ripe for simplification, both in terms of policy and legislative design. This Background Paper highlights the limits to legislative simplification that will exist unless there is a readiness to rationalise the policies and regulatory philosophies underlying the law and update the law and its architecture accordingly.

The Paper and the ALRC's Inquiry

9. The analysis in this paper has informed the ALRC's design of a legislative architecture that ensures that legislative complexity can be appropriately managed over time, while maintaining regulatory flexibility.[2] Overall, this Paper underlines the importance of: a clear and consistent legislative hierarchy that can facilitate reform with minimal complexity; regular review of existing provisions rooted in older regulatory philosophies; and a recognition that the policy positions of today may not be the policy positions of tomorrow. Designing a legal architecture that recognises these three elements would make for simpler and more adaptive financial services legislation.

2 Australian Law Reform Commission, 'Terms of Reference', *Review of the Legislative Framework for Corporations and Financial Services Regulation* (11 September 2020) <www.alrc.gov.au/inquiry/review-of-the-legislative-framework-for-corporations-and-financial-services-regulation/terms-of-reference/>.

Part One: Introducing risk

10. This Background Paper defines risk as 'the uncertainty about the outcome or payoff of an investment in the future'.[3] This definition is one quite specific to financial markets and services, and can be contrasted to the more colloquial definition of risk: 'the possibility of loss, injury, or other adverse or unwelcome circumstance; a chance or situation involving such a possibility'.[4] Far from being unwelcome, risk is an inevitable and, indeed, desirable feature of financial markets. The colloquial definition remains relevant, however, because it often the risk of financial loss that drives consumer decision making and to which regulation responds. But the first, more technical definition reflects the fact that particular risks are not inherently positive or negative, and must be understood in relation to the 'payoff' or return for bearing the particular risk.

Risk as a part of the financial system

11. Risk sits at the heart of the financial system. All financial products and services 'incorporate risk', and '[i]dentifying, allocating and pricing risk is a key role of the financial system'.[5] Some financial products, such as warranties and insurance, allow consumers to protect against risks of loss (but carry risks of their own). These products will often be priced for the risk the insurer is taking on from the consumers. Smokers and young drivers, for example, may pay more for life or car insurance. Other financial products require consumers to assume risks through an investment, such as by purchasing shares in a company, or through an investment vehicle (such as a superannuation fund). In making investment decisions, consumers have to balance 'the chance of positive returns against the risk of loss'.[6] In theory, this requires an investor to make judgements about a range of other risks, such as inflation, foreign currency, or liquidity risks. For example, investments in a fund that holds mostly European shares may fall in value if the value of the Australian dollar increases relative to the Euro (assuming the fund's returns are denominated in Euros, which are now worth less in Australian dollars). The inverse is also true: if the Australian dollar falls, some investments will become more valuable. Acquiring credit, such as residential loans, credit cards, or buy now pay later, carries the risks of 'indebtedness and/or interest rate increases'.[7]

3 Ronald W Melicher and Edgar A Norton, *Introduction to Finance: Markets, Investments, and Financial Management* (John Wiley & Sons, 16th ed, 2016) 8.

4 *Oxford English Dictionary* (online at 1 July 2021) 'risk, *n.*' (def 1). See also *Macquarie Dictionary* (online at 1 July 2021) 'risk' (def 1): 'exposure to the chance of injury or loss; a hazard or dangerous chance'. The ALRC acknowledges that this is a colloquial understanding of risk. In mathematics and economics, the concepts of risk and uncertainty have been the subject of continuous and ongoing debate as to their contours: John Maynard Keynes, 'The General Theory of Employment' (1937) 51(2) *The Quarterly Journal of Economics* 209, 214; Frank H Knight, *Risk, Uncertainty and Profit* (Riverside Press, 1921); Niall Ferguson, *The Ascent of Money: A Financial History of the World* (Penguin, 2008) 342–4; Mervyn King and John Kay, *Radical Uncertainty: Decision-Making for an Unknowable Future* (The Bridge Street Press, 2020); Peter L Bernstein, *Capital Ideas Evolving* (Wiley, 2009). In this literature, risk is inherently linked to probability theory. Risk is quantifiable, as in there being a 20% chance of rain tomorrow or a 1 in 8 million chance of a shark killing a swimmer. Risks can be contrasted to 'uncertainties', a point made by the economists Frank Knight in 1921 and John Maynard Keynes in 1937. Knight noted that '[u]ncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated … A measurable uncertainty, or "risk" proper… is so far different from an unmeasurable one that it is not in effect an uncertainty at all.' But scholars have disagreed on where risk ends and uncertainty or unknowability begins. Given this, we use the more colloquial understanding of risk in which 'possibility' is the focus, thus reducing the theoretical difference between 'uncertainties' and 'risk'.

5 Stan Wallis et al, *Financial System Inquiry* (Final Report, March 1997) 179.

6 Australian Securities and Investments Commission and Dutch Authority for the Financial Markets, *Disclosure: Why It Shouldn't Be the Default* (Joint Report No 632, October 2019) 10.

7 Ibid.

12. The financial system also exposes its participants to other types of risks. For example, every financial transaction is accompanied by 'counterparty risk'. This refers to the potential that the firm with which a customer is dealing may not be able to meet some or all of its obligations towards the customer. For instance, insurance held with an insolvent insurer will not protect the customer against the insured risks. Counterparty risk is among the most prevalent risks because anyone holding a financial product — even something as basic as a bank account — is exposed to the possibility that the product provider will go bankrupt, or fail to perform its side of the bargain for some other reason. Prudential regulation — which is discussed in Part Four of this Paper — is squarely aimed at managing, in some parts of the financial system, the institutional and systemic risks that increase counterparty risk.

Accepting risk

13. As noted, a degree of risk is unavoidable and, indeed, desirable in financial markets and services.[8] Risk is also constantly evolving with the development of new financial products and services, and the increasing complexity of existing products. Recent examples include a range of derivative products such as contracts for difference ('CFDs') that are linked to cryptocurrencies or other crypto-assets. Financial markets also see the emergence of new risks or risks that gain greater prominence. Examples of such risks include climate risk and environmental, social, and governance risks.

14. The existence and acceptance of risk in financial markets makes financial services regulation fundamentally different from other areas of regulation that seek to eliminate risk to a greater extent, such as consumer goods safety regulation.[9]

Risk and return

15. Historically, since at least the Campbell Inquiry and the deregulation of financial markets in the 1980s, the regulatory philosophy for financial services has not focused on significantly reducing the risks faced by consumers.[10] This has been justified on the basis that risk is not only an inevitable part of financial markets, but a desirable feature. The Campbell Inquiry emphasised the importance of a 'reasonably full spectrum of risk/return combinations' being 'available to investors'.[11] The Inquiry noted that excessive government regulation 'might create a "gap" in the investment risk spectrum'.[12] Risk gaps would mean that 'investors … do not have available to them an asset which involves a moderate degree of risk'.[13] The need for a risk spectrum that includes higher risk products is based in part on the view that higher risk investments can be good for the economy — 'a necessary part of innovation and competition'.[14] Individuals, as illustrated by the Campbell Inquiry's views, also need access to products that incorporate a spectrum of risks, based on their risk tolerance and capacity (see Figure 1).

8 Ashley Black and Pamela Hanrahan, *Securities and Financial Services Law* (LexisNexis Butterworths, 10th ed, 2021) 5.
9 Wallis et al (n 5) 189–190.
10 There are important exceptions to this general approach in prudentially regulated institutions and products, where a willingness to intensively regulate financial promises and the ability to meet them was accepted. See Part Four of this Background Paper.
11 JK Campbell et al, *Australian Financial System: Final Report* (Final Report, September 1981) 286.
12 Ibid 327.
13 Ibid 4. Campbell also noted the importance of risk-free assets, which could be provided by 'indexed government securities': 743.
14 Productivity Commission, Australian Government, *Competition in the Australian Financial System* (Inquiry Report No 89, June 2018) 16.

Figure 1: Risk tolerance and capacity

Risk tolerance refers to the willingness of a person to bear the likelihood of an adverse financial event or the general uncertainty or volatility that accompanies investments. This may be affected by a person's characteristics, such as age, employment status, experience, and wealth. Younger people may be more tolerant of risk because they have time to make up for losses through years of future employment. Alternatively, they may be less tolerant of risk as a result of the need to save for a home deposit or to generate income to service a mortgage. People with a higher risk tolerance may prefer shares in companies with more speculative growth prospects, or be willing to experiment with high-risk cryptocurrencies, while those with a lower risk tolerance may prefer to keep more of their wealth in bonds, term deposits, cash, or the equity in their homes. People with more financial experience may be willing to engage in higher-risk investing strategies, such as by using leverage (ie borrowing money to invest).

Risk capacity refers to someone's ability, as distinct from willingness, to bear the consequences of, and absorb any losses arising from, a financial investment. People with more wealth are more likely to be able to endure a soured financial investment, assuming they have diversified and not exposed all of their wealth to the same risk.

16. The risk spectrum only makes sense because individuals and organisations who bear risks are willing to do so in return for the possibility of being rewarded. This is the allocative function of financial markets — risks can be shifted from those less willing and able to bear them to those more willing and able to bear them. In the market economy, these risks are allocated for a price.

17. This illustrates the concept of the 'risk/return' relationship, which is fundamental to the pricing of financial products and services. The Campbell Inquiry noted that 'investments which offer equal risk/return combinations are priced equally and borrowers with equal risk are offered similar terms and conditions'.[15] Likewise, the Wallis Inquiry considered that risk, 'in an efficient system, is priced to reward those who bear it'.[16]

18. At the core of the risk and return relationship is a trade-off: people who are willing to bear more risk generally stand to gain higher returns. For example, investors in the stock market generally receive an equity risk premium relative to persons holding less risky assets, such as bonds.[17] Banks who lend to high-risk borrowers will demand a higher interest rate, and life insurers will charge higher premiums to cigarette smokers. The willingness to carry risks brings with it the possibility of greater reward.

15 Campbell et al (n 11) 1.
16 Wallis et al (n 5) 299.
17 Ferguson (n 4) 125–6. Bondholders enjoy priority over shareholders in bankruptcy proceedings.

19. A range of financial instruments and intermediaries have been developed to allocate and carry risks in the financial system. For example, the Wallis Inquiry identified financial products including 'swaps, futures, options and forward contracts' as managing risks 'such as movements in currencies and interest rates, share prices and commodities'.[18] Airlines often buy oil futures contracts, a type of derivative, to manage their exposure to commodity risks (ie the risk of the price of oil increasing).[19] If the price of oil rises, the airline can offset the higher costs with profits derived from its futures contracts. The other party in the transaction, perhaps a hedge fund, is paid for their willingness to bear the risk of oil prices falling. If the fund considers the likelihood of oil prices falling is high, it will demand a higher risk premium (ie a higher price for taking the risk).

Risk and regulation

20. While not a focus of this Background Paper, it is useful to recognise the increasing role that risk has played in the methodologies underlying regulation. Risk-based regulation has become increasingly embedded in the practices of regulators since the early 2000s, and this has shaped their approaches in financial services. The ALRC outlined risk-based regulation in Interim Report A of the Financial Services Inquiry.[20]

A changing Australian financial system

21. Before considering the changes that have occurred in the regulation of risk in Australia's financial system, it is necessary to understand two aspects of the broader context. Two significant and related consumer-facing changes have formed the backdrop to these changes: the 'risk shift' from government and employers to individuals that has occurred over the past thirty years, and the accelerated financialisation that has accompanied this development.[21] These trends were apparent at the time of the 1996 Wallis Inquiry, but their development and impact have increased significantly since then. These consumer-facing trends have also been accompanied by changes in regulatory theory, including the development of the field of behavioural economics.

Risk shift

22. The 'risk shift' refers to the increasing risks individuals have taken on, as opposed to employers or governments.[22] Some of these risks have resulted from deregulation. For example, the movement away from interest rate controls, in conjunction with a lack of long-term fixed-rate residential mortgages such as those in the US,[23] has meant that households bear the risk of interest rate movements on their home loans. Likewise, as Wallis observed in 1996, 'governments have sought, through superannuation initiatives, to encourage reduced dependence by retirees on the age pension'.[24] Subject to the age pension, which provides a floor to retirement incomes, this has shifted the risk of having sufficient funds to support people in retirement from governments to the individual. There has also been a move away from defined-benefit retirement savings products, whether provided by employers or super funds, and towards accumulation funds.[25] Accumulation funds, as opposed to defined-benefit funds, mean that individuals directly bear market performance risks and face a variable rate of return, and therefore a variable income stream in retirement (unless an individual acquires an annuity).

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18 Wallis et al (n 5) 166.
19 Tanya Powley, 'Ryanair Hit by Wrong Way Bet on Fuel', *Financial Times* (online, 3 April 2020) <www.ft.com/content/8f6ec56a-accc-4b51-96ff-89f32ed5a7bc>.
20 Australian Law Reform Commission, *Interim Report A: Financial Services Legislation* (Report No 137, November 2021) 81–2.
21 These changes are in addition to other developments, such as the internationalisation and deregulation of Australian financial markets.
22 John Quiggin, 'Risk Shifts in Australia: Implications of the Financial Crisis' in Greg Marston, Jeremy Moss and John Quiggin (eds), *Risk, Welfare and Work* (Melbourne University Press, 2010) 3–23.
23 C Breidbach et al, *FinFuture: The Future of Personal Finance in Australia* (University of Melbourne, 2019) 5.
24 Wallis et al (n 5) 81.
25 Breidbach et al (n 23) 5.

Financialisation

23. Increased individual exposure to risk has been accompanied by increasing exposure to financial assets and markets in particular, and the overall growth of the financial sector relative to the real economy. Scholars commonly refer to these trends as 'financialisation'.[26] Financialisation has meant that the overall size of the financial sector has grown enormously, while the proportion of financial wealth has increased relative to non-financial wealth (such as net equity in real-estate).[27] Within financial wealth, there has been a move to market-linked investments, such as publicly-listed shares held within a superannuation fund.[28] As Wallis noted, 'Australian households now rely more on the financial system and have greater exposures to particular financial service providers and to the financial system generally'.[29]

24. As at March 2021, every percentage point increase in the proportion of household wealth held in financial assets is equivalent to an increase of $152 billion. The 5 percentage point increase from 1988 to 2021 therefore means that individuals have $760 billion more in financial assets than would have been the case if the proportions remained as they were in 1988. The 11 percentage point increase since 1980 is equivalent to $1.67 trillion in March 2021 dollars.[30]

25. Financialisation has accompanied massive increases in the value of financial markets and financial assets. Based on ABS data,[31] the total financial assets of Australian households were valued at over $478 billion in June 1988. In March 2001, near the introduction of the Corporations Bill into the Commonwealth Parliament, this had increased to $1.3 trillion. By March 2021, the total wealth of Australian households in financial assets was $6.24 trillion — an increase of more than 450% in 20 years. All figures above and below are unadjusted for inflation.

26. Increases in household financial wealth are tied to increases in the size and diversity of Australian financial markets. The total size of financial markets,[32] as measured by the ABS's Australian National Accounts, increased from $1.3 trillion in June 1988, to $4.3 trillion in March 2001, and to $19.5 trillion in March 2021. To put this in context, Australia's annual GDP was $345 billion in 1988, $730 billion in 2001 and just under $2 trillion in the 2020-21 financial year.[33] Particular financial markets have also exploded in size. The market for derivatives and employee share schemes increased from $120 billion in March 2001 to over $720 billion in March 2021, down from $1.2 trillion in March 2020.

27. The increasing size of financial markets and their increased importance to the economy and households — and the risks that this brings for household wealth — have provided a critical backdrop to regulatory developments for at least the past twenty years. The Wallis Inquiry argued that these trends highlight 'the importance of the overall efficiency and safety of the financial

26 Natascha van der Zwan, 'Making Sense of Financialization' (2014) 12(1) *Socio-Economic Review* 99; Jeffrey M Chwieroth and Andrew Walter, 'Financialization, Wealth and the Changing Political Aftermaths of Banking Crises' (2020) *Socio-Economic Review* (Forthcoming); Gerald A Epstein, 'Introduction: Financialization and the World Economy' in Gerald A Epstein (ed), *Financialization and the World Economy* (Edward Elgar, 2005).

27 Financialisation has seen household wealth in financial markets increase from 30% of total assets in 1980 to 36% in September 1988, to 38.80% in March 2001, and to 40.99% in March 2021: Australian Law Reform Commission, 'Interim Report A: Financial Services Legislation' (n 20) 107.

28 Wallis et al (n 5) 81. Almost all the increased exposure to financial markets has been due to increased exposure to market-linked investments. The proportion of household wealth in superannuation, shares, and other market-linked assets increased from 21% in September 1988 to 30% in March 2021: Australian Law Reform Commission, 'Interim Report A: Financial Services Legislation' (n 20) 107.

29 Wallis et al (n 5) 86.

30 Figures calculated from ABS data by the ALRC based on the overall value of household wealth in March 2021: Australian Bureau of Statistics, 'Australian National Accounts: Finance and Wealth', *National Accounts* (24 June 2021) Table 35 <www.abs.gov.au/statistics/economy/national-accounts/australian-national-accounts-finance-and-wealth/mar-2021>.

31 Ibid.

32 This refers to the sum of total assets outstanding at end of period for various financial instruments. See Tables 39–49 of the Australian Bureau of Statistics (n 30).

33 Federal Reserve Bank of St. Louis, 'Current Price Gross Domestic Product in Australia', *FRED* <fred.stlouisfed.org/series/AUSGDPNADSMEI>. These figures are not seasonally adjusted or inflation adjusted.

system'.[34] CLERP 6 emphasised that 'the increasing exposure of household investment to market risk underscores the importance of effective regulation of Australian financial markets'.[35] More recently, the Productivity Commission noted in 2018 that the

> vital importance of financial services to the ongoing operation and the growth prospects of the economy, as well as the extent of information asymmetry, build a strong case for a high level of regulatory intervention. The objective of intervention is to reduce risk, generally.[36]

28. As this Background Paper will demonstrate throughout, the increased exposure of consumers to financial markets, the 'risk shift' identified above, and the dramatic increases in the scale and complexity of such markets, has provided the backdrop to enhanced regulatory interventions.

Part Two: Product risks

29. In Australia, financial regulation designed to protect consumers has historically focused on ensuring that 'adequate information [is] available to assist investors in assessing the risks and expected returns attached to various financial assets'.[37] Efficient financial markets, in which products are priced according to their expected risks and returns, are thought to require the reduction of information asymmetries (that is, the discordance between information known by the buyers and sellers of products). Reducing asymmetries requires disclosure of information to persons deciding whether to buy particular financial products, including information that will enable those buyers to assess the potential risk/return trade-off (such as the product's features, estimated return, duration etc) and make an informed decision as to whether to buy the product.[38] Disclosure rules seek to ensure that market participants can understand, measure, and manage the various risks to which they are or may be exposed.[39] This Part considers how this philosophy has been implemented, and explores how shifts in understandings of risk have led to legislative reforms that incorporate more prescriptive and interventionist regulatory philosophies. This Part demonstrates the key themes of this paper: the legislative architecture has shaped how reforms to manage product risk have occurred, and reforms have been accompanied by an unwillingness to revisit existing regulation embedded in older regulatory philosophies.

The Wallis Inquiry and financial services reform

30. The Wallis Inquiry situated disclosure 'at the core of any scheme to protect consumers as it allows them to exercise informed choice'.[40] Product disclosure, the Inquiry recommended, should be consistent across similar products, as well as 'comprehensible and sufficient to enable a consumer to make an informed decision relating to the financial product'.[41] The Department of the Treasury's CLERP 6 reforms required disclosure of 'the fundamental terms and obligations attaching to a financial product as well as the risks involved with the product'.[42] The regulatory philosophy underlying these reforms was one of contractual freedom.[43] Consumers were assumed

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34 Wallis et al (n 5) 86.

35 Department of the Treasury (Cth), *Financial Markets and Investment Products: Promoting Competition, Financial Innovation and Investment* (Corporate Law Economic Reform Program, Proposals for Reform: Paper No 6, 1997) 17.

36 Productivity Commission, Australian Government (n 14) 14.

37 Campbell et al (n 11) 3.

38 Ibid.

39 However, regulation has never meant perfect information: '[a]mong the risks that investors may be rewarded for bearing are those deriving from imperfect information': Wallis et al (n 5) 251. This means that people will always have an imperfect understanding of the risks they face, such as the likelihood of a company going bankrupt, a financial promise not being kept, an economic downturn, or interest rates rising.

40 Ibid 261.

41 Ibid 264. The Inquiry also proposed a range of reforms to disclosure in relation to the offers of securities, though these will not be further considered in this section.

42 Department of the Treasury (Cth), *Financial Markets and Investment Products: Promoting Competition, Financial Innovation and Investment* (n 35) 4.

43 'In a market economy, consumers are assumed, for the most part, to be the best judges of their own interests': Wallis et al (n 5) 191.

to be broadly capable of making decisions about the right financial products to acquire, and to understand the risks associated with their acquisition. This decision-making process was to be supported by disclosure requirements, and reinforced by obligations regulating the conduct of financial product providers in the sale of their products. Those obligations include prohibitions on misleading and deceptive conduct and representations, and against unconscionable conduct.[44]

31. The Wallis Inquiry and CLERP 6 eventually saw the introduction of a new Part 7.9 in the *Corporations Act 2001* as part of broader amendments in the *Financial Services Reform Act 2001* ('*FSR Act*').[45] Part 7.9 introduced the product disclosure statement ('PDS') as the standard disclosure document for most financial products. Section 1013D of the Act outlines the required content of a PDS.[46] This includes 'information about any significant risks associated with holding the product'.[47] Various other information must also be contained in a PDS, in part to assist consumers in assessing (and comparing) risks. For example, s 1013D mandates disclosure of 'information about any significant benefits to which a holder of the product will or may become entitled, the circumstances in which and times at which those benefits will or may be provided, and the way in which those benefits will or may be provided'.[48] Such information allows consumers to consider the product's benefits and the way in which they are provided, and to consider those benefits against the risk of not receiving them (or experiencing losses). The information in a PDS is key to a consumer's assessment of a product's 'risk/return' trade-off. Further, where a product has an investment component, the Act requires disclosure of 'the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment'.[49] This information allows consumers to assess what are commonly known as 'ESG' (environmental, social, and governance) risks.

32. PDSs are therefore designed to function as the means by which consumers assess the risks and benefits of a product, and decide whether they should acquire the product in light of that assessment. Disclosure is intended to allow consumers to make informed decisions as to a product's risk/return trade-off and whether this is appropriate for them in light of their risk tolerance and capacity. As such, disclosure has been understood as being at the core of financial product regulation.

Making disclosure work better

33. Almost as soon as it was passed, the disclosure provisions in the *Corporations Act* began to evolve. Much of the 2000s and the early 2010s were spent trying to make PDSs, and other disclosure regimes, work better for consumers. This occurred in the context of a growing body of research highlighting the limitations of standardised disclosure and the ability of consumers to process information. The focus of policy-makers shifted to 'good' or 'effective' disclosure, including disclosure that was tailored to particular products and circumstances. Good disclosure, it was hoped, would better assist consumers in assessing the risks and benefits of financial products. Policy-makers also understood that excessive standardised disclosure was difficult for consumers to understand, and expensive for businesses to produce.

34. Even before the passage of the PDS regime in 2001, it was understood that disclosure had its limitations — hence the need for general conduct obligations (such as those against misleading or unconscionable conduct). Experimental research as early as the 1940s and 1950s had highlighted the limitations of theories that assumed the rationality of human decision-making,

44 *Australian Securities and Investments Commission Act 2001* (Cth) ss 12DA, 12DB, 12DC; *Corporations Act 2001* (Cth) ss 908DB, 1041E.
45 A range of other disclosure reforms were included in the *FSR Act*. See, for example, the introduction of Financial Services Guides in Part 7.7.
46 The information in s 1013D is not required in certain circumstances: s 1013F.
47 *Corporations Act 2001* (Cth) s 1013D(1)(c).
48 Ibid s 1013D(1)(b).
49 Ibid s 1013D(1)(l).

on which much standardised disclosure was premised. Allais, for example, found that 'in a context of risky outcomes, the key factor for the decision-maker is the risk level of the selected option' in an absolute sense — which was prioritised over consideration of the likelihood of financial loss and return.[50] Research into human decision-making further accelerated with the work of Daniel Kahneman and Amos Tversky, which challenged assumptions about how humans understand and cope with risk, probabilities, and uncertainties.[51] Behavioural economics, as this field of study would become known, garnered popular awareness in the 2000s, most notably as a result of the book *Nudge* by Richard Thaler and Cass Sunstein.[52]

Precursors to better disclosure

35. More prescriptive intervention in consumer decision-making — as represented by 'good' or 'effective' disclosure and 'nudges' — was not without precedent in Australian law. The *Insurance Contracts Act 1984*, from its inception, prescribed a 'standard cover regime' for certain insurance contracts. This regime included minimum claim amounts and cover, as provided in the *Insurance Contracts Regulations*. Insurers could opt out of the minimum standard cover provided that they 'clearly informed the insured in writing … or the insured knew, or a reasonable person in the circumstances could be expected to have known,' that they were not covered by the standard cover.[53] Insurers were also required to notify insureds of any contractual provision 'of a kind that is not usually included in contracts of insurance that provide similar insurance cover'.[54] Notification could occur by giving the insured a copy of the insurance policy or by demonstrating that the insurer 'clearly informed the insured in writing of the effect of the provision'.[55] Both these steps were early examples of 'nudges', and the ALRC pointed to the potential for information asymmetries and information overload from disclosure when it recommended such a regime in 1982.[56]

36. The enhanced disclosure for unusual contract terms recognised that consumers were unlikely to fully understand the risks covered by the insurance, based on the general description of the product.[57] While insurers could derogate from the standard cover, consumers were 'nudged' to consider whether they were happy with this reduced cover. Tailored and enhanced disclosure is therefore nothing new in Australian law. Nonetheless, the scope of reforms made to the PDS and other disclosure regimes in the 2000s and 2010s is notable, and reflects the development of behavioural economics and an appreciation of the increased risks consumers have borne with the financialisation of the Australian economy.

Legislating for better disclosure

37. Reforms to disclosure introduced immediately after the commencement of the *Corporations Act* were aimed at reducing the volume of information provided to consumers, or tailoring how or when it would be provided. Tailoring initially occurred through regulations such as reg 7.9.02A,[58] which allowed PDSs to be given in certain ways so long as the consumer agreed. Likewise, reg 7.9.07B adapted standard disclosure provisions for certain market-traded derivatives.[59] Tailoring regulation to reflect the degree of risk was also reflected in the definition of 'retail client' in new regulations. These regulations sought to exclude persons who were 'better able to assess the

50 Anne-Francoise Lefevre and Michael Chapman, Behavioural Economics and Financial Consumer Protection (OECD Working Papers on Finance, Insurance and Private Pensions No 42, 2017) 5.
51 Daniel Kahneman and Amos Tversky, 'Prospect Theory: An Analysis of Decision under Risk' (1979) 47(2) *Econometrica* 263.
52 Richard Thaler and Cass Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* (Yale University Press, 2008). For a discussion of these developments, see Lefevre and Chapman (n 50) 6.
53 *Insurance Contracts Act 1984* (Cth) s 35.
54 Ibid s 37.
55 Ibid.
56 Australian Law Reform Commission, *Insurance Contracts* (Report No 20, 1982) xxvi. The ALRC's report also underlines how far disclosure has come in the past forty years: the ALRC suggested in the 1981 review that 'there should be no requirement that an insurer should, in every case, provide the insured with a copy of his contract': Ibid xxiv.
57 Australian Law Reform Commission, 'Insurance Contracts' (n 56) 30, 44.
58 *Corporations Amendment Regulations 2002 (No. 2)* (Cth).
59 Ibid.

risks involved in financial transactions' from the definition of retail client,[60] which meant they did not receive various mandated disclosure. ASIC also made a number of legislative instruments that reduced disclosure requirements for some lower-risk products.[61]

38. Further amendments in 2001 sought to tailor PDS requirements for different products and circumstances. For example, reg 7.9.15 required enhanced disclosure in relation to insurance products issued by unauthorised foreign insurers, because such products were regarded as carrying greater risks for consumers. Superannuation and retirement saving account products were also subject to more detailed disclosure requirements. However, disclosure for capital guaranteed superannuation products and retirement savings account products were 'subject to differing requirements from other regulated superannuation products due to their lower risk-return nature'.[62] Good disclosure also came with an understanding that the way information is provided to consumers is important, which was reflected in a range of reforms.[63]

39. Significant reforms to PDSs occurred in 2005 with new exemptions that sought to reduce the volume of redundant information given to consumers, and with a new 'short-form PDS' regime. For example, new regulations 'turned off' a range of disclosure provisions that applied to general insurance products.[64] Regulation 7.9.15D turned off the requirement that insurers disclose 'significant risks associated with holding the product' because government 'considered that insurers appropriately disclose risks' through other arrangements.[65] Regulation 7.9.15E required certain enhanced disclosure to draw terms and conditions to a consumer's attention. New regulations also exempted certain products from the PDS regime in particular circumstances, including for simple low-risk products like basic deposit products.[66]

40. It was the 'short-form PDS' regime that marked the first concerted effort to improve financial product disclosure. The Explanatory Statement accompanying the changes noted that

> PDSs have as a rule turned out to be complex and lengthy documents. Consumer feedback suggests that the average retail investor finds it difficult to absorb the large volume of information in some PDSs, and is therefore deterred from using the information to make investment decisions. …
>
> The overall intention is to give financial product providers the flexibility to create a document that is not only shorter, but also more tailored to the individual product, and that is written in a manner that is more appealing and informative for the retail client.[67]

41. The shift towards shorter disclosure documents was part of an international trend, and driven in significant part by findings from behavioural research.[68] In Australia, it also led to the shorter-

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60 See *Corporations Amendment Regulations 2001 (No. 4)* (Cth) regs 7.1.11–7.1.28; Explanatory Statement, Corporations Amendment Regulations 2001 (No. 4) (Cth).

61 See, for example, *ASIC Class Order — Investor directed portfolio services* (CO 02/294) 296; *ASIC Class Order — Nominee and custody services* (CO 02/295) 296; *ASIC Class Order — Managed Discretionary Accounts* (CO 02/296) 296; *ASIC Class Order — Managed Discretionary Accounts* (CO 04/194) 194.

62 *Corporations Amendment Regulations 2001 (No. 4)* (Cth) reg 7.9.11, schs 10B, 10C; Explanatory Statement, Corporations Amendment Regulations 2001 (No. 4) (Cth).

63 The *Corporations Regulations* were amended four months after their Gazettal to provide that s 1015C of the *Corporations Act* was modified so that the Regulations could provide 'for the format of a Product Disclosure Statement, including the location of particular statements or information': *Corporations Amendment Regulations 2001 (No. 4)* (Cth) s 5.1. Section 1015C already provided that the regulations could mandate the 'presentation, structure and format for a Statement that is to be given in electronic form'.

64 *Corporations Amendment Regulations 2005 (No. 5)* (Cth) regs 7.9.15D, 7.9.15F.

65 Explanatory Statement, Corporations Amendment Regulations 2005 (No. 5) (Cth) 24.

66 *Corporations Amendment Regulations 2005 (No. 5)* (Cth) reg 7.9.07FA. In addition to their low-risk, the Explanatory Statement noted that providers of such products generally complied with ASIC's *Guide to Good Transaction Fee Disclosure for Bank, Building Society and Credit Union Deposit and Payments Products*, which 'contains principles for effective disclosure': Explanatory Statement, Corporations Amendment Regulations 2005 (No. 5) (Cth) 21.

67 Explanatory Statement, Corporations Amendment Regulations 2005 (No. 5) (Cth) 13.

68 Andrew Godwin and Ian Ramsay, 'Financial Products and Short-Form Disclosure Documents: A Comparative Analysis of Six Jurisdictions' (2015) 10(2) *Capital Markets Law Journal* 212, 213; Andrew Godwin and Ian Ramsay, 'Short-Form Disclosure Documents—An Empirical Survey of Six Jurisdictions' (2016) 11(2) *Capital Markets Law Journal* 296, 300.

PDS regime in respect of certain financial products. Research suggests that the Australian reforms have been notably unsuccessful in simplifying product disclosure.[69] Notably, these reforms, like many in this period, were introduced through notional amendments to the *Corporations Act*,[70] a particularly complex means of lawmaking.

42. Under the Australian reforms, short-form PDSs could be given to consumers instead of a PDS, but product issuers were still required to prepare a PDS and consumers were entitled to request one. The short-form PDS was required to contain ‘a summary of defined core information relating to the product’.[71] This included information on significant risks associated with the product, and information required by s 1013D (that would allow consumers to assess the risk/return trade-off).[72] The principle that consumers were best placed to make decisions about their exposure to risk was core to all of these reforms. Regulation was adapted to suit products, and the risks of those products, but the ultimate responsibility still lay with the consumer, who it was assumed would consider the disclosures before making a decision. However, significant changes to this philosophy came in 2009 and 2010.

Disclosure and regulatory risks

43. Risks to consumers undoubtedly played an important role in shaping the design and reforms of the disclosure regime in the 2000s. However, the detailed disclosure provisions included in the *FSR Act*, and the move to make these more prescriptive in the subsequent decade, may also have been driven by financial services law seeking to reduce other types of risk: compliance and regulatory risks. It is possible that companies sought more detailed disclosure requirements in an effort to increase certainty as to their legal obligations, and thereby to address the regulatory or compliance risks that a more principled framework may be perceived to introduce. However, attempts to facilitate compliance through prescription has meant that the law may fail to achieve its more fundamental objective of consumer protection. This is because prescriptiveness can itself introduce risks of non-compliance by increasing the complexity and sheer scale of the legislation, thereby making it harder to understand and enforce.

44. There is also a more fundamental sense in which prescriptive disclosure can distract from broader obligations that licensees and other providers of financial products and services have in relation to consumers. Disclosure can be perceived as a risk shift — having informed a consumer of the risks in a product or service, a company may feel that it has executed its responsibilities.[73] This can detract from the broader conduct obligations that providers of financial products have to retail clients. In particular, an emphasis on prescriptive disclosure requirements, including as to the content and form of information, may focus compliance on black and white aspects of the law, rather than the more indeterminate requirements imposed by prohibitions such as that against misleading and deceptive conduct or the requirement that AFS licensees act efficiently, honestly, and fairly. Incidents such as the collapse of Storm Financial and examples from the Financial Services Royal Commission (‘FSRC’) also illustrate the way in which complying with disclosure provisions may create a sense of licence to disregard consumer interests or generally accepted norms of conduct, whether in the law or not. Prescriptive content and timing requirements, such as in relation to Statements of Advice for personal advice, may also simply reduce the time that can be given to actually providing advice, and add to the costs of such advice. The fundamental obligations of an advisor — to act in the best interests of the client — can be overwhelmed by the disclosure obligations to which an advisor is subject.

69 Australia’s short-form PDSs are ‘overwhelmingly considered to be the hardest to read’ among comparable jurisdictions: Godwin and Ramsay, ‘Short-Form Disclosure Documents—An Empirical Survey of Six Jurisdictions’ (n 68) 297.

70 Largely contained in Schedule 10BA of the *Corporations Regulations 2001*.

71 Explanatory Statement, Corporations Amendment Regulations 2005 (No. 5) (Cth) 13.

72 See s 1017I, as notionally inserted by Schedule 10BA in *Corporations Amendment Regulations 2005 (No. 5)* (Cth).

73 There is evidence for this in relation to conflicts of interest, for example: Australian Securities and Investments Commission and Dutch Authority for the Financial Markets (n 6) 42.

Legislating to reduce product risks

45. The introduction of responsible lending requirements, provisions invalidating unfair contract terms, MySuper, and payday loan reforms, marked significant shifts in how regulation addressed risks facing consumers in the acquisition of financial products.[74] Both represented shifts from disclosure-led regulation to more interventionist forms of consumer protection. They also resulted from a more explicit focus on risks faced by consumers, which had been more implicit in the early- to mid-2000s.[75] However, in building new regulatory regimes, policymakers left the old disclosure regimes largely intact (and in some instances even increased their scale). This remains a persistent theme in financial services law: the slow accretion of laws and regulatory regimes reflecting new regulatory philosophies, with little desire to revisit or dismantle what came before.

Responsible lending

46. Disclosure was a central feature of consumer protection under each Australian state's Uniform Consumer Credit Code (UCCC).[76] Pre-contractual disclosure was based on the 'principle of truth-in-lending', which it was presumed would 'allow borrowers to make informed choices when purchasing credit'.[77] This reflected the objective of never 'restricting product flexibility and consumer choice'.[78] Any risks associated with a product, including affordability risks and the risk of non-payment, would be left to consumers.[79]

47. Responsible lending reforms were informed by two trends at the core of this Background Paper: increased engagement with behavioural economics, and accelerating financialisation. The Productivity Commission's 2008 work that led to responsible lending appears to have been heavily influenced by the growing body of research into human behaviour and decision-making.[80] The Commission observed that 'behavioural economists have drawn on longstanding insights into human behaviour to question whether consumers always behave in what standard economic analysis suggests is their best interests, even where they are adequately informed'.[81] While the Commission

> has often not explicitly separated behavioural rationales from other reasons for policy intervention, it sees the findings of behavioural economics as relevant to the design of consumer policies in a range of specific areas.[82]

48. Nonetheless, the contribution of behavioural economics 'lies in enriching existing analytical frameworks and improving the design and implementation of specific policies, rather than in providing a superior alternative framework'.[83] The attachment to the existing analytical framework explains the continued focus on disclosure in financial services regulation.[84]

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74 Responsible lending also reflected concerns as to the conduct of lenders and financial intermediaries. See [46]–[50] for discussion of responsible lending in this context.
75 Gail Pearson, 'Risk and the Consumer in Australian Financial Services Reform' (2006) 28 *Sydney Law Review* 99, 100.
76 See, for example, *Consumer Credit (New South Wales) Act 1995* (NSW) Consumer Credit Code ss 14–15.
77 Explanatory Note, Consumer Credit (New South Wales) Bill 1995 (NSW) 1.
78 Ibid 1–2.
79 Effective prudential regulation theoretically means that no lender should be able to systematically engage in irresponsible lending. However, such regulation is not aimed at ensuring the provision of appropriate credit to any particular consumer. See also Explanatory Memorandum, National Consumer Credit Protection Bill 2009, 3.15: the state regimes do not 'comprehensively address the appropriateness of the initial provision of the credit to the consumer'.
80 An entire appendix was given over to behavioural economics: Productivity Commission, Australian Government, *Review of Australia's Consumer Policy Framework* (Report No 45, Vol 2, April 2008) Appendix B.
81 Ibid 32.
82 Ibid 12.
83 Ibid 8.
84 See [55]–[57].

Figure 2: Examples of observed behavioural patterns[85]

Under-estimating low probabilities: A study of horseracing showed that punters generally over-bet on longshots. For example, horses with 2 per cent of the total money bet on them win only about 1 per cent of the time**.**

Overconfidence: A study showed that 80 per cent of respondents rated themselves in the top 30 per cent of drivers.

49. The Productivity Commission observed that rapid increases in the size of Australian consumer credit markets 'may well mean that modifications or augmentations to the regulatory regime are warranted'.[86] This financialisation, which had seen the real value of consumer loans grow at an annualised rate of 5 per cent since 1988, meant that household debt levels were 'at historically high levels'.[87] The risks to consumers had grown accordingly, and could affect 'household financial capacity and ability to respond to changing circumstances such as interest rate increases, a slowdown in economic conditions or rising unemployment'.[88] Responsible lending, in requiring that lenders, lessors, and intermediaries provide credit that is not 'unsuitable', responded to changes in how regulation understands consumer behaviour, and to the increased risks consumers faced as a result of their increased exposure to financial markets. In a legislative intervention that would likely have been regarded as objectionable by the Wallis Inquiry, lenders were required to refuse credit where 'the consumer will be unable to comply with the consumer's financial obligations under the contract, or could only comply with substantial hardship'.[89] They also had to refuse credit where it would not meet a 'consumer's requirements or objectives'.[90] These obligations marked a considerable departure from a regulatory philosophy that positioned disclosure as the principal means of consumer protection.

50. The mixture of regulatory philosophies implicit in the Productivity Commission's report was evident in the responsible lending reforms. The *National Consumer Credit Protection Act 2009* includes prescriptive and detailed disclosure requirements in the form of credit guides,[91] serving a similar purpose to PDSs for non-credit financial products. The late 2000s therefore mark the beginning of a shift in financial regulation to a more mixed regulatory philosophy. The Productivity Commission's report made clear that consumers still bore responsibility for their decisions, but that consumers could no longer be presumed to be the best guardians of their own interests (including in relation to the risks they assumed in financial markets).

Unfair contract terms

51. The introduction of unfair contract term ('UCT') provisions in the *ASIC Act* and the Australian Consumer Law was also the result of the Productivity Commission's Review of Australia's Consumer Policy Framework.[92] The Commission's proposed ban on UCTs sought to address the fact 'that consumers may underestimate certain risks'.[93] While the Review gave consideration to enhanced disclosure of unfair terms and mandatory cooling-off periods, the Commission concluded that consumers would be unlikely to genuinely engage with such disclosure or consider the risks and

85 Productivity Commission, Australian Government (n 80) 380.
86 Ibid 446.
87 Ibid 444.
88 Explanatory Memorandum, National Consumer Credit Protection Bill 2009 (Cth) [3.8].
89 *National Consumer Credit Protection Act 2009* (Cth) s 131(2)(a).
90 Ibid s 131(2)(b).
91 Ibid pt 3-2, div 2.
92 The Ministerial Council on Consumer Affairs had considered a uniform ban in state legislation since August 2002 and Victoria had introduced a ban on UCTs in 2003: Productivity Commission, Australian Government (n 80) 56, 59.
93 Ibid 422.

benefits of an unfair term.[94] The reforms were calibrated to balance consumer and seller interests. The upfront price in a contract, for example, would not be an unfair term under the reforms, because these 'cannot legitimately be seen as surprises veiled by a complex contract'.[95] Likewise, the Commission proposed a model that did not allow regulators to 'pre-emptively rule out unfair terms that could cause (future) detriment to consumers'.[96] Instead, it would be necessary to show that actual contracts were entered into and that consumer detriment flowed from the inclusion of an unfair term.[97] UCTs were part of a new regulatory philosophy in which it was presumed that consumers would not consider all the risks and benefits involved in acquiring a product.

MySuper

52. The introduction of the MySuper suite of reforms was, like responsible lending, a response to the recognised flaws of human decision-making and the increased exposure of consumers to risks in financial markets. Superannuation carried with it the expectation that consumers would effectively manage financial risks to maximise their retirement income and achieve a better outcome than the age pension would allow. MySuper defaulted people into super products with a 'single diversified investment strategy'.[98] A person could choose to leave this default option and select another product or investment strategy, but would have to actively make this choice. The Super System Review (2009–10), which recommended MySuper, endorsed the 'nudge'-based language of 'choice architecture' in proposing a system that was designed,[99] by default, against 'investment choice'.[100] This system rejected the idea that consumers should be expected to assess investment risks and select the appropriate product or strategy for their circumstances. The Review pointed to 'inadequate levels of financial literacy and appreciation of risk' and 'complex disclosure needed to understand' the available options in rejecting the expectation of decision-making by consumers.[101] The Review also justified the reforms in the context of financialisation, with 'the superannuation system … expected to grow to $6.1' trillion by 2035.[102] According to the Review, this context necessitated a new regulatory architecture.

53. Disclosure still occupies a place of 'paramount importance' in the new architecture.[103] Those who decide to leave the default MySuper options 'bear substantial responsibility for the investment choices or fund choices that they made', albeit 'with trustee responsibility for reasonable due diligence on investment options offered'.[104] MySuper, in seeking to preserve consumer choice while ensuring a reasonable default option for disengaged consumers, was a manifestation of behavioural economics in policy and law design. It was a 'nudge' embedded in law.[105] The reforms marked yet another shift in the regulatory philosophy underpinning financial services law — one in which the role of choice by consumers was increasingly circumscribed.

94 Ibid 157.
95 Ibid 162.
96 Ibid 165.
97 Ibid 166.
98 *Superannuation Industry (Supervision) Act 1993* (Cth) s 29TC.
99 Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System, Attorney-General's Department, *Super System Review* (Final Report, Part 1, June 2010) 9.
100 Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System, Attorney-General's Department, *MySuper: Optimising Australian Superannuation* (Second Phase One — Preliminary Report, April 2020) 4.
101 Ibid.
102 Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System, Attorney-General's Department, 'Super System Review' (n 99) 5.
103 Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System, Attorney-General's Department, *Super System Review* (Final Report, Part 2, June 2010) 8.
104 Ibid.
105 Thaler and Sunstein's book of the same name appeared in the second footnote of Part 2 of the Super System Review's *Final Report*.

Payday loan and other 2012 credit reforms

54. A more interventionist regulatory philosophy was also reflected in 2012 reforms to the cost of small amount credit. These reforms sought to 'address particular risks identified' in relation to small amount credit contracts, as well as consumer leases and reverse mortgages.[106] The reforms included a cap on the cost that lenders could charge for some small amount credit contracts (being contracts for credit of $2,000 or less). The reforms also imposed a 'more restrictive cap on all other credit contracts'.[107] The reforms were aimed at reducing risks to consumers: the caps, for example, addressed 'specific risks of financial detriment or harm to consumers'.[108] The reforms were, in part, a response to the increased understanding that consumers — particularly those in financial distress — may not make informed decisions about the financial risks of taking on high-cost credit. Reforms relating to reverse mortgages also sought to limit consumer exposure to risk, particularly the potential that people could borrow so much as to eventually have negative equity in their houses (where the amount of the loan exceeds the value of the house).[109] The Explanatory Memorandum emphasises the particular 'difficulty in managing the risk of negative equity'.[110] Again, however, these reforms reflected the mixture of more interventionist consumer protections with a regulatory philosophy based on disclosure. A range of new disclosure requirements were mandated in the reform Bill (and the content of two disclosures regimes prescribed in the regulations),[111] reflecting a continued shift towards tailored and behaviourally informed disclosure obligations.

Disclosure is dead. Long live disclosure.

55. In the course of the 2000s and early 2010s, behaviourally informed disclosure, and disclosure adapted to particular products and circumstances, increasingly replaced the standardised disclosure regimes of the Wallis Inquiry and the *FSR Act*. In 2009, the Commonwealth took over the regulation of margin loans, which received a tailored disclosure regime.[112] Pursuant to the shorter-PDS regime as previously noted, certain superannuation products and simple managed investment schemes were also subject to highly prescriptive regimes governing the content, manner, and form of their product disclosure statements.[113] The Regulation Impact Statement for these reforms acknowledged that 'there has been considerable discussion about the overall effectiveness of current PDSs', and noted that the length of PDSs varied 'between 46 and 154 pages for superannuation products, and 32 and 124 pages for MIS [Managed Investment Scheme] products'.[114] It was recognised that the ability of consumers to assess the 'inherent risks associated with certain types of financial products' was undermined by complex disclosure documents.[115]

56. Outside the *Corporations Act*, enhanced and simplified disclosures — in the form of Key Fact Sheets ('KFS') — were introduced for a range of financial products. Home loans and credit

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106 Explanatory Memorandum, Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2011 (Cth) [1.5].
107 Ibid [1.14].
108 Ibid [5.6]
109 Ibid [3.1]. Reverse mortgages allow a person to borrow money from a financial institution while using the person's home as security for the loan. As long as the person continues to live in the home they do not need to make repayments on the loan. The interest payable on the loan compounds and increases the total amount repayable, and which is secured against the home. The loan is repaid when the person dies or sells the property. Depending on the size of the loan and the age of the borrower, interest can significantly increase the total amount repayable.
110 Ibid [10.14].
111 See the reverse mortgage information statement (ss 5(1), 133DB(1)(d)) and website requirements for small amount credit providers (s 124B). Other disclosure requirements included a lessor's obligation to account (sch 1, pt 11, div 5) and a requirement to give projections of equity in relation to reverse mortgages (s 133DB(1)(a)). These provisions were inserted into the *National Consumer Credit Protection Act 2009* (Cth) in the *Consumer Credit Legislation Amendment (Enhancements) Act 2012* (Cth).
112 *Corporations Regulations 2001* (Cth) Schedule 10C. See also the various other amendments made by *Corporations Amendment Regulations 2010 (No. 5)* (Cth), including to Schedule 10A.
113 Ibid schs 10D, 10E.
114 Regulation Impact Statement, Corporations Amendment Regulations 2010 (No. 5) (Cth) [8].
115 Ibid [13].

cards became subject to a KFS regime in 2011. The Explanatory Memorandum emphasised the benefits of KFS over longer-form disclosure, suggesting that research from the UK 'found that consumers are using the KFI [the UK equivalent] to better understand the risks and features of the mortgages they take out, including the affordability risks'.[116] KFSs were also introduced for certain types of insurance policies in 2012 following devastating natural disasters in several states.[117] In endorsing KFSs for home insurance, the Natural Disaster Insurance Review found that the existing disclosure regime had 'failed to sufficiently inform consumers' of the risks covered by their insurance policies, including whether the policies covered flood risks.[118]

57. The accumulation of these reforms meant that, by 2013, the standard financial product disclosure regime in Part 7.9 of the *Corporations Act* had been so completely modified as to be unrecognisable.[119] It had also ceased to be 'standard' given how many products were subject to tailored regulatory regimes. The vast majority of the disclosure provisions introduced in the *FSR Act* and in the course of the 2000s remained in the *Corporations Act*, despite a recognition that the 'legislation surrounding disclosure is very complex'.[120] Writing in 2021, Tapley and Godwin suggested that there 'is good reason to question whether the current disclosure regime is coherent and achieves the outcomes it is designed to achieve'.[121] The regulatory philosophies underpinning the law had evolved, but the reforms had simply added to its volume and complexity.

Evolution or revolution? DDOs and PIOs

58. The Murray Inquiry published its final report in November 2014. While both the Wallis Inquiry and the Murray Inquiry were referred to as a 'Financial System Inquiry', they each surveyed very different regulatory and legislative landscapes. The Murray Inquiry represented an effort to reconcile the regulatory and legislative architecture of the 1996 Wallis Inquiry with the changes in financial markets and regulatory expectations that had occurred since 1996. Whereas Wallis spoke of 'fair and efficient markets',[122] Murray spoke of markets 'characterised by the fair treatment of users'.[123] A weakness of the current regulatory settings, Murray suggested, was that 'unfair consumer outcomes remain prevalent'.[124] This focus on consumer outcomes, rather than a more systemic focus on market outcomes,[125] underlined the fact that the Murray Inquiry embodied a different regulatory philosophy from that of the Wallis Inquiry. Concerns about how consumers engage with risk sat at the heart of many of the Murray Inquiry's recommendations:

> Consumers should have the freedom to take financial risks and bear the consequences of these risks. However, the Inquiry is concerned that consumers are taking risks they might not have taken if they were well informed or better advised.[126]

59. The focus of the Wallis Inquiry was on creating a fair playing ground on which consumers could transact. Regulation in the post-Wallis period was characterised by a focus on 'the three

116 Revised Explanatory Memorandum, National Consumer Credit Protection Amendment (Home Loans and Credit Cards) Bill 2011 (Cth) [5.55].

117 Revised Explanatory Memorandum, Insurance Contracts Amendment Bill 2012 (Cth) [2.2].

118 Department of the Treasury (Cth), *Natural Disaster Insurance Review: Inquiry into Flood Insurance and Related Matters* (Final Report, September 2011) 103.

119 ASIC legislative instruments that imposed tailored product disclosure requirements include *ASIC Class Order — Investor Directed Portfolio Services Provided Through a Registered Managed Investment Scheme* (CO 13/762); *ASIC Class Order — Investor Directed Portfolio Services* (CO 13/763); *ASIC Class Order — Managed Discretionary Accounts* (CO 04/194). For a discussion of the extensive role of delegated legislation in financial product disclosure, see Phoebe Tapley and Andrew Godwin, 'Disclosure (Dis)Content: Regulating Disclosure in Prospectuses and Product Disclosure Statements' (2021) 38 *Company & Securities Law Journal* 315, 328–30.

120 Regulation Impact Statement, Corporations Amendment Regulations 2010 (No. 5) (Cth) [13].

121 Tapley and Godwin (n 119) 330.

122 Wallis et al (n 5) 178.

123 David Murray et al, *Financial System Inquiry* (Final Report, November 2014) xiii.

124 Ibid.

125 The chapter in the Wallis Inquiry report devoted to the philosophy of financial regulation made reference only to 'market outcomes' and 'efficient markets'.

126 Murray et al (n 123) 28.

building blocks of disclosure, education and advice'.[127] Disclosure and general protections against, for example, insider trading and misleading conduct, would seek to guarantee a fair market. But there was no particular emphasis on whether any particular consumer or class of consumers would in fact achieve good outcomes. The years between Wallis and Murray had seen this regulatory philosophy challenged by changed understandings of consumer behaviour and increased financialisation.[128] Legislative interventions such as those described in the preceding paragraphs had increasingly sought to protect consumers from risks in financial markets by imposing significant conduct obligations on firms. The Murray Inquiry concluded that new understandings of the financial system had 'reduced the Inquiry's confidence in the inherent efficiency and stability of financial markets'.[129] Nonetheless, the Murray Inquiry did not seek to completely abandon the regulatory philosophy of the Wallis Inquiry. In summarising general principles for policymakers, Murray suggested that

> Consumers should generally bear responsibility for their financial decisions, but should be able to expect financial products and services to perform in the way they are led to believe they will.[130]

60. In at least two of its recommendations, however, the Murray Inquiry underlined just how much this principle was subject to the caveat that consumers should 'generally' be responsible for their decisions.

Design and distribution obligations

61. Design and distribution obligations ('DDOs') marked a significant shift in the regulation of financial products in Australia. These obligations reflect a regulatory philosophy in which sellers of financial products — and not simply consumers — bear responsibility for ensuring that the products are suitable for their end-users. In doing so, DDOs strengthen 'product issuer and distributor accountability'.[131] At the core of DDOs is the requirement on financial firms to identify a 'target market' for a financial product, and then to develop product distribution processes that ensure sales of the product are directed only to consumers within that target market. The Murray Inquiry, which recommended the reforms, indicated that the 'risk/return profile' of a product was a central consideration in identifying a target market.[132] In other words, consumers should not be expected, based only on product disclosures, to determine whether a product is appropriate for them. Product issuers and distributors would also be expected to periodically review whether a product's 'risk profile is consistent with its distribution' to the target market.[133] For example, a target market may need to be narrower if an issuer determines that the product is higher risk than expected. Murray considered that DDOs would reduce the incidence of calamities like Storm Financial,

> where margin lending products did not suit consumer risk profiles, such as those approaching retirement who could only cover significant losses by selling the family home. Close to 2,800 consumers faced around $500 million net losses.[134]

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127 Kevin Davis, 'The Australian Financial System in the 2000s: Dodging the Bullet' in Hugo Gerard and Jonathan Kearns (eds), *The Australian Economy in the 2000s: Proceedings of a Conference* (Reserve Bank of Australia, 2011) 313.

128 Murray et al (n 123) 8–9. On page 28, the Inquiry also pointed to consumer losses as a basis for the need to intervene: 'Previous collapses involving poor advice, information imbalances and exploitation of consumer behavioural biases have affected more than 80,000 consumers, with losses totalling more than $5 billion, or $4 billion after compensation and liquidator recoveries'. Financialisation had made the scale of these losses greater, and increased the number of consumers exposed to failures.

129 Ibid 8.

130 Ibid 12.

131 Ibid 198.

132 Ibid.

133 Ibid.

134 Ibid 202.

62. DDOs were designed to 'assist consumers to obtain appropriate financial products'.[135] While exemptions from the obligations exist for some financial products (such as certain superannuation interests), the vast majority of financial products provided to retail clients are subject to DDOs.

63. In other ways, DDOs embed the language of risk in consumer financial regulation. As the Explanatory Memorandum explains, DDOs require issuers and distributors to use risk management approaches in taking 'reasonable steps' to ensure products are distributed consistently with the target market determination.[136] The legislation also encourages a risk management approach in determining a 'reasonable review period' for target market determinations.[137]

64. A notable feature of DDOs that sets them apart from many previous reforms is the complete lack of a disclosure element. Interventions such as MySuper, caps on the cost of credit, and responsible lending, were accompanied by disclosure reforms. Disclosure was considered integral to the objectives of each new reform. Even UCT provisions required courts to have regard to the extent to which unfair terms were 'transparent' to a consumer (including the extent to which they were disclosed).[138] DDOs reflected a shift towards a regulatory philosophy in which disclosure was important but no longer understood as necessary to achieving fairer outcomes for consumers.

Product intervention powers

65. Product intervention powers ('PIPs'), in particular, are a departure from a regulatory philosophy of 'buyer beware'. Another recommendation of the Murray Inquiry, PIPs allow ASIC to make product intervention orders that ban the sale of a financial product to retail clients, or impose conditions on the sale of such products. The fact that PIPs sit uncomfortably with the regulatory philosophy of pre-existing law was underlined by the range of limitations and safeguards recommended by the Murray Inquiry.[139] PIPs can only be made where ASIC is satisfied that a financial product is creating the risk of significant consumer detriment to retail clients, and Murray recommended they be limited to only 12 months in duration (which became 18 months in the final law). After this, the Minister would have to approve an extension or the order would lapse. ASIC would need to consult APRA where APRA-regulated firms were affected, and Murray emphasised that the exercise of the power would be subject to judicial review.[140]

66. PIPs are an anomaly in financial regulation because they run completely contrary to the principle expressed in the Murray Inquiry that consumers 'should have the freedom to take financial risks and bear the consequences of these risks'.[141] Using PIPs, ASIC has the power to prohibit the sale of financial products — thereby completely depriving consumers of the ability to take on certain risks — or to impose conditions on a product that limit the risks a consumer can take. ASIC has used the power to make three product intervention orders since 2019. These ban the sale of binary options to retail clients;[142] limit the leverage retail clients can use on contracts for difference;[143] and cap the charges a consumer can pay on certain short-term credit.[144]

Binary options

67. The ban on binary options is an example of ASIC removing the ability of consumers to take certain financial risks. Binary options are a type of derivative 'that allow clients to make "all-or-

135 Revised Explanatory Memorandum, Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2019 (Cth) [1.5].
136 Ibid [1.95].
137 Ibid [1.65].
138 *Australian Securities and Investments Commission Act 2001* (Cth) s 12BG(2)–(3).
139 Murray et al (n 123) 206.
140 Ibid.
141 Ibid 28.
142 *ASIC Corporations (Product Intervention Order—Binary Options) Instrument 2021/240*.
143 *ASIC Corporations (Product Intervention Order—Contracts for Differences) Instrument 2020/986* (Cth).
144 *ASIC Corporations (Product Intervention Order – Short Term Credit) Instrument 2019/917* (Cth).

nothing" bets on the occurrence or non-occurrence of a specified event in a defined timeframe (e.g. the price of gold increasing in 30 seconds)'.[145] ASIC concluded that binary options posed an unacceptable risk to retail clients. ASIC suggested that

> we have found that disclosure alone is ineffective in helping retail clients to understand these risks because humans' ability to accurately assess abstract matters such as risk and probability is innately constrained, and these products are highly complex.[146]

68. ASIC's decision to ban binary options highlights the broader shift in regulatory philosophy that PIPs heralded. An observation that 'disclosure alone is ineffective' might previously have triggered a push for additional consumer protections, such as caps on trading amounts accompanied by enhanced or tailored disclosure. In contrast, ASIC simply banned the issue of binary options to retail clients. ASIC's conclusion that 'binary options provide no meaningful investment or economic utility' ran completely contrary to the principle that consumers should be able to look after their own interests and select their own financial risks.[147] ASIC's intervention shut down a market worth $490 million in 2018, in which 80% of clients lost money.[148]

Contracts for difference (CFDs)

69. ASIC's product intervention order in relation to contracts for difference ('CFDs') did not prevent consumers from acquiring such contracts. Instead, it imposed a range of conditions on issuers of CFDs that limited the risks retail clients could expose themselves to. CFDs are, like binary options, derivatives. They are leveraged[149] and 'allow clients to speculate on the change in the value of an underlying asset' such as a commodity, cryptocurrency, or other financial product.[150] They are often used to speculate on currency pairs (such as GBP/EUR). ASIC found that most clients lose money trading CFDs.[151]

70. ASIC's intervention, amongst other things, imposed limits on how much leverage retail clients could use, and required CFD issuers to limit client losses to the amount in the client's trading account. Retail clients would also have their positions closed if the 'funds in their CFD trading account' fell 'to less than 50% of the total initial margin required for all of their open CFD positions on that account'.[152] The leverage requirements and the margin close-out protection significantly reduced the risks retail clients could take on. Whereas a client could previously trade crypto-assets with as much as 500:1 leverage (putting up $1 for $500 worth of exposure), ASIC's intervention limited them to leverage of 2:1.[153] Nonetheless, in a sign that disclosure was still regarded as an essential regulatory tool, ASIC's consultation paper proposed new risk warnings and ongoing disclosure.[154] These did not make it into the final order because ASIC concluded that the other conditions would achieve the objectives of the order.[155] ASIC also suggested that 'consideration of academic research and anecdotal evidence' shows 'that risk warnings and disclosure can be less effective than expected or ineffective'.[156] In making an order that relied

145 Australian Securities and Investments Commission, *Product Intervention: OTC Binary Options and CFDs* (Consultation Paper No 322, August 2019) [5].
146 Ibid [83].
147 Ibid [145].
148 Ibid [68], [70].
149 This means that clients 'use a small initial investment (known as 'margin') to gain exposure to an asset for a proportion of that asset's value. For example, for a CFD contract with a leverage ratio of 200:1, a client would only have to deposit an initial margin of $5,000 to gain economic exposure of $1 million to the performance of the underlying asset': Ibid [39].
150 Ibid [36].
151 Ibid [89].
152 Ibid 46.
153 Leverage limits vary by asset type: ASIC Corporations (Product Intervention Order—Contracts for Difference) Instrument 2020/986 (Cth) s 7.
154 These were proposed conditions 5–8: Australian Securities and Investments Commission, *Product Intervention: OTC Binary Options and CFDs* (n 145) 46–7.
155 Explanatory Statement, ASIC Corporations (Product Intervention Order—Contracts for Difference) Instrument 2020/986 (Cth) [66(e)].
156 Ibid.

solely on new conduct obligations on the product issuer, and which quite dramatically reduced the risks retail clients could take, ASIC's CFD intervention was yet another example of the changing regulatory philosophy underpinning financial product regulation.

The retail client in Australian regulatory philosophy

71. Despite the shifting regulatory philosophies of the past 20 years, one constant has generally remained: reforms aimed at protecting against product risks have principally affected products issued to retail clients. The only significant shift in this regard has been to extend protections to small businesses. Small businesses first received protections under the *Trade Practices Act* in 1998. Subsequently, the Financial Services Reform Bill 2001 included the objective of ensuring that small businesses 'receive protection as retail clients under the regime'.[157] The Australian Consumer Law applied Unfair Contract Terms ('UCT') protections to small businesses in 2009.[158] Since then, UCT provisions have been extended to small businesses in the *ASIC Act*,[159] and it has been agreed these should be enhanced.[160]

72. Nonetheless, the definition of 'retail client', and terms that serve a similar purpose in legislation such as the *ASIC Act* ('consumer' — see s 12BC) and the *NCCP Act* ('provision of credit to which this Code applies' see *National Credit Code* s 5(1)(b)), have evolved at a glacial pace, if at all. In this way, they have been a notable source of continuity in the regulatory philosophy as to who should be protected.

Product risk: evolution and revolution

73. The 2017 FSRC marked the latest step in the development of financial services regulation. It recommended a number of reforms to protect consumers from product risks. This included the extension of UCT provisions to insurance contracts, and limits on the charging of default interest for agricultural loans. The FSRC also endorsed the Productivity Commission's earlier recommendation of a deferred-sales model for add-on insurance. As implemented in the *ASIC Act*, this prohibits the sale of certain insurance products sold with other goods or services for a period of four days after the good or service is acquired. Commissioner Hayne endorsed ASIC's justification for a deferred sales model, which was that it 'would give consumers additional time to navigate the complexities of add-on products and facilitate improved decision making'.[161] Nonetheless, most FSRC reforms related to the conduct of sellers and intermediaries, rather than the exposure of consumers to risks inherent in financial products.

74. So, in relation to how Australia regulates consumer engagement with financial product risks, have we seen a revolution or an evolution? The best answer is that we have seen a mix of the two, with a general evolution over the past twenty years in the use of disclosure and targeted consumer interventions. These have been interspersed with reforms that are arguably revolutionary in how they depart from previously existing regulatory philosophies on risk. Such revolutions include responsible lending, MySuper, DDOs, and PIPs. The Murray Inquiry suggested that the Stronger Super reforms, of which MySuper was an element, and the consumer credit reforms that included responsible lending, represented 'fundamental changes in the domestic regulatory framework'.[162]

75. But it is harder to conclude that a revolution has occurred in the regulatory philosophies that underpin how we regulate product risks and the consumer. A revolution suggests a break with

157 Revised Explanatory Memorandum, Financial Services Reform Bill 2001 (Cth) [2.28].
158 *Trade Practices Amendment (Australian Consumer Law) Act 2009* (Cth).
159 *Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Act 2015* (Cth).
160 'Meeting of Ministers for Consumer Affairs Friday 6 November 2020', *Australian Consumer Law* (6 November 2020) <https://consumer.gov.au/consumer-affairs-forum/communiques/meeting-12-0>.
161 Commonwealth of Australia, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, *Final Report* (Volume 1, February 2019) 289.
162 Murray et al (n 123) 29.

the past. Such a break with the past is not apparent in most of Chapter 7 of the *Corporations Act* and other financial services legislation. Instead, the development of financial services consumer protection over the past twenty years is arguably a result of decreased confidence in disclosure being sufficient to ameliorate risks. This reflected the development of behavioural economics and a growing body of literature suggesting that individuals understand risk poorly and

> that the effectiveness of many traditional consumer protection approaches is diminished once you can no longer assume that consumers will seek out and understand all relevant information before purchasing a financial product.[163]

76. But disclosure has never lost its place at the heart of financial product regulation. Financial product regulation has instead evolved, rather than been revolutionised, by the gradual accretion of additional laws and regulatory regimes. This accretion, emerging from a mix of regulatory philosophies and contexts and inconstantly spread across dozens of Acts, regulations and ASIC legislative instruments, is the basis of much of the legislative and regulatory complexity present in the law today. The failure to comprehensively review and simplify this law, to date, means that there are many ‘easy wins’ available to simplify the *Corporations Act* and financial product regulation. Such easy wins include consolidation of notional amendments and removal of the duplication, redundancy, and unnecessary prescription that has crept into the legislation over many years. However, more fundamental simplification will likely also require shifts in the law’s underlying policy, and the development of a more consistent regulatory philosophy for regulating financial products and the risks they pose.

Part Three: Conduct risk

77. A similar story to that told above for product risks can be told for how Australia regulates conduct risks. Conduct risk relates to the conduct of a product issuer or intermediary, such as the potential for conflicts of interest or misconduct in selling a financial product. Conduct risks to which consumers are exposed may or may not be prohibited by law, but they all pose the risk of consumer detriment. The law seeks to reduce or eliminate many conduct risks, such as through prohibitions on misleading or deceptive conduct and unconscionable conduct. However, the extent to which the law intervenes to address conduct risks facing consumers has grown significantly over the past twenty years. Increases in the intensity of that regulation have been accompanied by changes in how the law intervenes. Shifting regulatory philosophies underlie these changes. This section considers how these trends have affected two key sources of conduct risk facing consumers: conflicts of interest and sales conduct.

Conflicts of interest

78. The Wallis Inquiry was aware of the risks posed to consumers by conflicts of interest, particularly in relation to intermediaries such as financial advisors. The Inquiry, however, embedded proposals to address conflicts in the philosophy that consumers were the best guardians of their interests. Sufficiently informed of any conflicts of interest, a consumer would be able to weigh up the quality of the advice and any risk it was inappropriate. This had been the approach under earlier regulation of investment advisers, life agents, and brokers.[164] In proposing standardised disclosure for retail financial products, the Inquiry noted its belief

> that consumers need information about fees, commissions (including trailing commissions) and

163 Productivity Commission, Australian Government (n 14) 87. For a review of this literature, see Lefevre and Chapman n 50). See also Geraint Howells, ‘The Potential and Limits of Consumer Empowerment by Information’ (2005) 32(3) *Journal of Law and Society* 349; Kristy Johnston, Christine Tether and Ashley Tomlinson, ‘Financial Product Disclosure: Insights from Behavioural Economics’ (Occasional Paper No 15/01, Ministry of Business, Innovation and Employment (NZ), February 2015); Russell Korobkin, ‘Bounded Rationality, Standard Form Contracts, and Unconscionability’ (2003) 70 *University of Chicago Law Review* 1203.

164 Wallis et al (n 5) 263.

the remuneration paid to their financial advisers or brokers so that they can determine whether a recommendation is skewed in favour of a particular product.[165]

79. The Inquiry recommended that such disclosures occur for all products where 'commissions are deducted from the consumer's investment', which marked an extension of disclosure obligations from previous regulations.[166] The CLERP 6 process endorsed the Wallis Inquiry's approach, explicitly linking benefits to intermediaries and conflicts of interest.[167] Disclosure, CLERP 6 concluded, would assist clients 'in assessing the merits of a product recommendation' and would reduce 'the opportunity for advisers to act in self interest to the disadvantage of the client'.[168]

The Financial Services Reform Act 2001

80. The disclosure-based approach to conflicts of interest in the distribution of retail financial products was embedded in the *FSR Act*. Financial Services Guides ('FSGs') and Statements of Advice ('SOAs'), both implemented by the *FSR Act*, include a range of disclosures about remuneration and on whose behalf the provider of a financial service or product is acting.[169] The high-level obligations in the *Corporations Act* to disclose information that allows consumers to identify potential conflicts of interest were complemented by extensive and prescriptive regulations. As with disclosure for product risks, the regulations quickly became a vehicle for tailored disclosure regimes in relation to remuneration and other potential conflicts of interest. From 15 October 2001, almost immediately after passage of the *FSR Act*, additional regulations mandated 'more detailed statements in relation to the remuneration (including commission) and other benefits' in FSGs.[170] Similar regulations applied to SOAs.[171] The Explanatory Statement accompanying these changes emphasised that the SOA remuneration disclosures would assist consumers to compare 'similar products or services offered by other providers'.[172]

81. The *FSR Act* also introduced restrictions on use of the words 'independent', 'impartial', 'unbiased', or any similar terms where a financial services provider did not meet certain criteria. These could only be used where a person did not accept commissions, volume-based remuneration, or other gifts or benefits from an issuer of a financial product that may reasonably be expected to influence the person.[173] Use of the terms also required avoiding conflicts of interest that may 'arise from their associations or relationships with issuers of financial products' and 'reasonably be expected to influence the person in carrying on the business or providing the services'.[174] While more interventionist than disclosure, this restriction was consistent with a regulatory philosophy that sought to maintain a fair market by eliminating potentially misleading conduct. The overall philosophy underlying the FSG and SOA disclosure reforms was that consumers can, and should, make decisions about the risks of conflicts of interest, and the risks of potential harm that conflicts may create.

Initial reforms

82. Regulatory philosophies are apt to need revision as soon as they are implemented. The principal focus on disclosure-based regulation of conflicts of interest began to evolve in 2004. Events in Australia and internationally put a new focus on the importance of intermediary independence.

165 Ibid.
166 Ibid.
167 Department of the Treasury (Cth), *Financial Markets and Investment Products: Promoting Competition, Financial Innovation and Investment* (n 35) 102.
168 Ibid.
169 *Corporations Act 2001* (Cth) ss 947B(2)(d)–(e) , 942B(2)(d)–(f).
170 *Corporations Amendment Regulations 2001 (No. 4)* (Cth) regs 7.7.04, 7.7.07.
171 Ibid regs 7.7.11–7.7.12.
172 Explanatory Statement, Corporations Amendment Regulations 2001 (No. 4) (Cth).
173 *Corporations Act 2001* (Cth) s 923A.
174 Ibid 923A(2)(e).

A number of corporate failures had drawn attention to issues in auditor independence.[175] The independence of financial analysts also became a cause for concern in Australia and the United States,[176] with ASIC publishing a report suggesting that existing regulation was insufficient.[177] Under the regulations at the time, there was 'no explicit duty in relation to the management of conflicts of interest'.[178] The 2004 reforms prioritised auditor independence, but also saw the introduction of a new duty on all financial services licensees to

> have in place adequate arrangements for the management of conflicts of interest that may arise wholly, or partially, in relation to activities undertaken by the licensee or a representative of the licensee in the provision of financial services as part of the financial services business of the licensee or the representative.[179]

83. The Explanatory Memorandum to the reform Bill emphasised that this was not an effort to replace existing approaches to conflicts of interest. The reforms relied on ASIC guidance about 'the level and manner of disclosure of conflicts'.[180] Guidance would ensure that consumers 'could benefit from more transparent disclosure of conflicts'.[181] Overall, the initiative would 'deliver a market-based solution for managing conflicts of interest'.[182] While the 2004 reforms represented a shift in the regulation of conflicts of interest, it was a minor one. Self-regulation supported by ASIC guidance and improved disclosure, both voluntary and mandated, remained the core of the regulatory philosophy. However, the explicit focus on conflicts of interest was an early sign of potential changes ahead. It would be some time, nonetheless, before any significant changes occurred.

The Big Bang: FOFA

84. Few reforms to financial services law have been as significant as the 2012 Future of Financial Advice ('FOFA') reforms. In its two core reforms — a best interests duty for financial advisors, and a ban on conflicted remuneration relating to most financial product advice — FOFA represented a remarkable break from previous regulatory philosophies in how it addressed conflict of interest risks. What set FOFA apart from previous reforms were two underlying observations, in part influenced by behavioural economics.

85. The first observation related to consumers. Disclosure, the FOFA Explanatory Memorandum indicated, is simply incapable of sufficiently informing consumers as to the risks of conflicts of interest, and consumers are 'unable to assess the impact of the conflict on the advice received'.[183] Consumers trust their advisors too much to be able to make such assessments. In the end, disclosure could not eliminate the difficulty consumers have 'understanding the impact of the remuneration on advice'.[184] The second observation related to advisors and financial services firms. It was, the Bill concluded, impossible to 'manage' the risk of conflicts of interest created by certain remuneration arrangements. Despite obligations to manage conflicts, 'commission-based remuneration arrangements, sales and volume incentives and the use of asset based fees' had

175 Explanatory Memorandum, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth) [4.8].
176 Ibid [4.155].
177 Ibid [4.156].
178 Ibid [4.152].
179 *Corporations Act 2001* (Cth) s 912A(1)(aa).
180 Explanatory Memorandum, Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003 (Cth) [4.158], [4.169].
181 Ibid [4.159].
182 Ibid [4.169].
183 Revised Explanatory Memorandum, Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 (Cth) [3.69].
184 Ibid [3.72].

continued to result in a range of problems.[185] In the end, 'the inherent sales versus advice conflict may continue to misalign the interests of the consumer and adviser'.[186]

86. Financialisation had increased the exposure of individuals to financial risks, and thereby made the consequences of conflicts of interest more politically and economically salient. The Explanatory Memorandum cited ASIC's view that the collapse of Storm Financial during the Global Financial Crisis 'may be an example of the potential impact on clients of failure to manage conflicts of interest created by commissions and remuneration based on funds under advice'.[187] The 2009 Ripoll Inquiry considered the Storm Financial collapse in depth,[188] concluding that

> disclosure documents are too long and confusing for conflicts of interest caused by commission-based remuneration and vertical ownership structures to be properly understood by consumers. The documents are so inaccessible that they are probably not read at all by most people. There are also limits as to the usefulness of disclosure, however clear and concise, in an environment where clients have already committed in their mind to their trusted adviser's chosen strategy.[189]

87. The insufficiency of disclosure and the impossibility of appropriately managing some conflicts of interest justified the shift to eliminating some of their sources. The ban on conflicted remuneration for financial products (other than insurance) represented the principal means of targeting these risks. The ban covered monetary and non-monetary benefits, and applied to both general advice and personal advice. In its scope, the ban was sweeping (with notable exceptions for general and life insurance,[190] and a more targeted exemption for basic banking products).[191] It was accompanied by specific bans on volume-based shelf-space fees (from asset managers or product issuers to platform operators), and asset-based fees on borrowed amounts.[192]

88. FOFA's attempt to eliminate conflict of interest risks was accompanied by obligations that sought to more intensively manage remaining conflicts, such as those based on ownership. FOFA introduced a best interests duty for providers of personal financial product advice.[193] The Bill also introduced a requirement that such providers give priority to their client's interests.[194]

89. Disclosure had its place in these reforms. Ongoing fee disclosures were targeted at the risk of 'disengaged clients … paying ongoing financial advice fees where they are receiving little or no service'.[195] The Bill assumed that financial advisors would not necessarily act to notify or engage with such clients. Disclosure of an ongoing fee relating to a period longer than 12 months, it was hoped, would nudge a consumer to consider whether the ongoing fees were worthwhile, and ongoing fees that went for longer than 24 months required a fee disclosure statement and a renewal notice to the client.[196] Moreover, the disclosure provisions that had been introduced in the *FSR Act* (and tweaked through changes to the Act and regulations in the 2000s) remained largely intact. Regulatory interventions were built on top of regulatory interventions, but little thought was given to repealing or simplifying the older provisions.

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185 Ibid [3.23].
186 Ibid [3.69].
187 Ibid [3.44].
188 Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Inquiry into Financial Products and Services in Australia* (Report, November 2009) Chapter 3.
189 Ibid 87.
190 *Corporations Act 2001* (Cth) ss 963B(1)(a)–(b).
191 Ibid s 963D.
192 Ibid ss 964–964H.
193 Ibid s 961B.
194 Ibid s 961J.
195 Revised Explanatory Memorandum, Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011 (Cth) [1.5].
196 Ibid [1.7].

Building on FOFA

90. A number of reforms were made to the FOFA regime between 2014 and 2016.[197] In particular, reforms to address conflicts of interest and other conduct risks in financial advice were made following the Murray Inquiry and an inquiry by the Parliamentary Joint Committee on Corporations and Financial Services,[198] both in 2014. Despite earlier reforms, the Murray Inquiry had identified ongoing problems among financial advisors 'relating to shortcomings in disclosure and financial advice, and an over-reliance on financial literacy'.[199] Two Acts in 2017 made reforms aimed at improving standards for financial advice. The *Corporations Amendment (Professional Standards of Financial Advisers) Act 2017* imposed more prescriptive training requirements and a new mandatory Code of Ethics. The Code of Ethics, which was finalised in 2019, had a clear focus on addressing conflicts of interest. Three of the 11 standards in the Code addressed these goals:

> Standard 2: You must act with integrity and in the best interests of each of your clients.
>
> Standard 3: You must not advise, refer or act in any other manner where you have a conflict of interest or duty.
>
> Standard 5: All advice and financial product recommendations that you give to a client must be in the best interests of the client and appropriate to the client's individual circumstances.[200]

91. The new Code of Ethics went further than the existing obligations in the *Corporations Act*. It was not, for example, subject to safe harbours in relation to its best interests duty. Likewise, the *Corporations Act,* in its exemptions for certain types of conflicted remuneration, permitted potential conflicts of interest, which in the Code were prohibited under Standard 3. The professional standards reforms marked a further shift away from regulation that assumed consumers could assess the risks associated with conflicts of interest in relation to their financial advisors.

92. Broader reform came with the *Corporations Amendment (Life Insurance Remuneration Arrangements) Act 2017*, which affected both personal and general advice. This Act sought to limit the scope of the exemption for life insurance conflicted remuneration by granting ASIC the power to impose limits on the levels and types of remuneration. The amendments came in response to evidence that life insurance remuneration structures were incentivising poor advice and advisors acting in their own interests.[201] The Act (and associated ASIC legislative instrument) had the aim of better aligning 'the interests of consumers and those providing life insurance advice'.[202] ASIC's instrument imposed caps on the level of commissions,[203] and required scaled 'clawback' arrangements under which commissions needed to be repaid where a consumer cancelled or did not renew a product within particular periods.[204] The life insurance remuneration reforms represented the continued implementation of a philosophy that conflicts of interest needed to be eliminated, rather than simply managed. Disclosure played no role in either the professional standards or life insurance remuneration reforms. Neither reform expected consumers to better understand or manage the conflicts of interest to which they were exposed.

197 See, for example, *Corporations Amendment (Statements of Advice) Regulation 2014* (Cth); *Corporations Amendment (Revising Future of Financial Advice) Regulation 2014* (Cth); *Corporations Amendment (Financial Advice) Regulation 2015* (Cth) 201; *Corporations Amendment (Financial Advice Measures) Act 2016* (Cth).

198 Parliamentary Joint Committee on Corporations and Financial Services, Parliament of Australia, *Inquiry into Proposals to Lift the Professional, Ethical and Education Standards in the Financial Services Industry* (Report, December 2014).

199 Explanatory Memorandum, Corporations Amendment (Professional Standards of Financial Advisers) Bill 2016 (Cth) [7.12].

200 *Financial Planners and Advisers Code of Ethics 2019* (Cth) s 5.

201 Australian Securities and Investments Commission, *Review of Retail Life Insurance Advice* (Report No 413, October 2014) [157]–[167].

202 Explanatory Statement, ASIC Corporations (Life Insurance Commissions) Instrument 2017/510 (Cth) 2.

203 *ASIC Corporations (Life Insurance Commissions) Instrument 2017/510* (Cth) s 5.

204 Ibid s 6.

The Financial Services Royal Commission

93. The FSRC, and the reforms implemented in its wake, represent the most significant effort to target conflicts of interest since the FOFA reforms. Commissioner Hayne's articulated regulatory philosophy marked a departure from that in the Wallis Inquiry. While the Wallis Inquiry considered that disclosure of conflicts of interest was key, Commissioner Hayne considered that

> [w]here possible, conflicts of interest and conflicts between duty and interest should be removed. There must be recognition that conflicts of interest and conflicts between duty and interest should be eliminated rather than 'managed'.[205]

94. Nine of the 76 FSRC recommendations related to conflicts of interests.[206] Just one of these recommendations (2.2 — financial advisers disclosing any lack of independence) principally involved disclosure. Other recommendations were to impose conduct obligations on financial services licensees or advisors that sought to eliminate sources of conflict risks, or to more intensively manage them through best interest duties.

95. In relation to conflicted remuneration, the FSRC recommended that

a. conflicted remuneration for mortgage brokers should be banned (Recommendation 1.3);

b. grandfathered commissions which had been exempt from the FOFA reforms should be eliminated (Recommendation 2.4);

c. unless ASIC concluded there were compelling justifications to retain them, the cap on conflicted remuneration for life risk insurance products should eventually be set at zero (Recommendation 2.5);

d. the review of measures to improve the quality of advice (Recommendation 2.3) should consider whether key exemptions from the bans on conflicted remuneration remained justified, notably for general insurance products and consumer credit insurance products (Recommendation 2.6); and

e. ASIC should be given the power to impose caps on the commissions payable in relation to add-on insurance products (Recommendation 4.4).

96. Commissioner Hayne also recommended the imposition of a best interests duty for mortgage brokers (Recommendation 1.2). These recommendations reflected a continued evolution of the regulatory philosophy underlying the regulation of conduct risks.

97. The legislation implementing several of these reforms involved a compromise between the evolving regulatory philosophy and the perceived impact of bans on conflicted remuneration on the cost of advice. Instead of banning conflicted remuneration for mortgage brokers, the eventual reforms to the *NCCP Act* and regulations restricted the conflicted remuneration payable to brokers.[207] The permitted monetary benefits were 'directed at ensuring the benefits are transparent and do not negatively impact consumers',[208] and there were a limited number of exemptions for non-monetary benefits.[209] The best interests duty, however, was implemented through a broad obligation on brokers,[210] which lacked the safe harbours available under the FOFA reforms. The

205 Commonwealth of Australia, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (n 161) 45.

206 Ibid.

207 Reforms were implemented through amendments in the *Financial Sector Reform (Hayne Royal Commission Response—Protecting Consumers (2019 Measures)) Act 2020* (Cth) and the *Financial Sector Reform (Hayne Royal Commission Response—Protecting Consumers) (Mortgage Brokers) Regulations 2020* (Cth).

208 Replacement Explanatory Statement, Financial Sector Reform (Hayne Royal Commission Response – Protecting Consumers) (Mortgage Brokers) Regulations 2020 (Cth) 1.

209 Ibid.

210 *National Consumer Credit Protection Act 2009* (Cth) s 158LA. There is also an obligation to, in the event of a conflict, give priority to the interests of a consumer over the interests of the brokers: s 158LB.

ban on grandfathered commissions was also implemented,[211] and ASIC now has the power to cap commissions in relation to add-on insurance for motor vehicles.[212] The review of conflicted remuneration for life insurance, general insurance, and consumer credit insurance, will form part of Treasury's Quality of Advice Review, the terms of reference for which were released in March 2022.

Twenty years of change

98. The regulation of conflicts of interest risks facing consumers has undergone a dramatic evolution over the past twenty years. Today, there is broad agreement — reflected in the *Corporations Act* and the *NCCP Act* — that disclosure is not a particularly effective way to address conflict risks. Consumers cannot generally be expected to identify conflict risks and take steps to ameliorate them. Bans and restrictions on conflicted remuneration have instead reduced or eliminated sources of conflict risks across most financial services, and best interests duties for financial advisors and brokers have sought to more intensively manage remaining conflicts where they are most likely to affect consumers.

99. Despite the shift in regulatory philosophies these reforms represented, the disclosure architecture of the 2001 *FSR Act* remains untouched, with extensive prescription in relation to the disclosure of remuneration and conflicts in FSGs and SOAs. In addition to the disclosure provisions in the Act, a range of regulations and ASIC legislative instruments affect the operation of the conflicts disclosure regime.[213] In leaving the older regimes intact, this history underscores the fact that the complexity of the legislative regime broadly reflects the accretion of regulatory philosophies without a broader architecture for managing change. Little thought appears to have been given to how disclosure could be simplified given the changed risks to consumers resulting from reforms to eliminate and reduce conflicts of interest. This is in part because the policy in relation to conflict risks remains an agglomeration of regulatory philosophies. Conflicts and conflicted remuneration have not been eliminated in areas such as personal advice and the distribution of financial products, and disclosure therefore remains necessary, despite the imposition of a range of new conduct obligations. The mixture of regulatory philosophies will remain a source of inevitable complexity, necessitating exemptions and tailored regulatory regimes. Nonetheless, there remains the potential to rationalise the provisions without changing the policy settings through reliance on more principled obligations for disclosure and removing much of the prescription that has evolved but been made less relevant with the introduction of new conduct obligations. The adoption of a consistent legislative hierarchy, as discussed below in relation to systemic risk in Part Four, may reduce the complexity of the exiting legislation. Regardless, reviewing the approach to conflicts risk underlines the extent to which Australian financial services regulation has been driven by shifting approaches to risk, informed at various points by factors such as developments in behavioural economics, increasing financialisation, and amplified consumer exposure to risks.

211 *Treasury Laws Amendment (Ending Grandfathered Conflicted Remuneration) Act 2019* (Cth).

212 *Financial Sector Reform (Hayne Royal Commission Response) Act 2020* (Cth) sch 4. ASIC has not exercised the power.

213 *Corporations Regulations 2001* (Cth) regs 7.7.04–7.7.04AB, 7.7.05C, 7.7.07–7.7.07A, 7.7.10A, 7.7.11–7.7.13B; *ASIC Corporations (Disclosure in Dollars) Instrument 2016/767* (Cth).

Sales conduct

100. Increasingly interventionist approaches have characterised the regulation of risks relating to sales conduct. The Wallis Inquiry said little about sales conduct, and the CLERP 6 process emphasised only a need to address risks of pressure selling in some contexts.[214] When it was passed, the *ASIC Act 2001* contained a number of general protections relating to the sale of financial products. These included prohibitions on misleading or deceptive conduct, unconscionable conduct, harassment and coercion, and pyramid-selling of securities. The Act also included restrictions on offering gifts and prizes, bait advertising, referral selling, and unsolicited debit cards. The *FSR Act* also introduced a number of prohibitions relating to the hawking of financial products.[215] These applied in relation to certain financial products when offered to retail clients. The hawking prohibition in s 992A, however, had a major exemption in subsection (3), which significantly reduced the scope of the ban by exempting cold calling by sellers of financial products in certain situations. Retail clients also had a right to a cooling-off period in relation to a limited number of financial products,[216] which it was thought would act as a safeguard where misconduct occurred at the point of sale (such as pressure selling). There was also the general obligation on financial services licensees that they behave 'efficiently, honestly and fairly',[217] though a breach of this requirement was neither a civil penalty nor an offence at the time of the *FSR Act* in 2001.

A long intermission

101. Unlike the law in relation to product risks, the regulation of sales conduct risks saw few reforms between the enactment of the *FSR Act* and the FSRC. This reflected a more sustained willingness to rely on general consumer protections and extensive (and growing) disclosure provisions. Some of the reforms in relation to product risks and conflict of interest risks also had intended or unintended effects on sales conduct. Responsible lending, for example, arguably reduced the scope of pressure selling, given lenders were required to assess the 'unsuitability' of the credit. Caps on the cost of credit likewise restricted the ability of sellers to push consumers to accept very high-cost credit. Reforms to the regulation of conflicts of interest clearly had an impact on the motivations that might lead an intermediary to engage in inappropriate sales conduct. But interventions that more directly regulated sales conduct, including the manner in which products could be sold, were absent.

The Financial Services Royal Commission

102. Sales conduct became a central focus of the FSRC. Commissioner Hayne concluded that, in the lead up the FSRC, '[s]ales became all important', relegating '[p]roviding a service to customers … to second place'.[218] As discussed in relation to conflict of interest risks, the FSRC considered that remuneration and incentives were key causes of conduct that did not meet community expectations. However, several recommendations sought to address sales conduct risks without necessarily affecting remuneration practices. Three examples are notable, all of which fell under the heading of '[m]anner of sale and types of product sold'.[219]

103. The first was the ban on hawking financial products. The earlier ban introduced by the *FSR Act* proved to be flawed because of its exemption for unsolicited sales calls (provided certain criteria were met). The exemption resulted in extensive cold calling, causing a range of poor

214 Department of the Treasury (Cth), *Financial Products, Service Providers and Markets – An Integrated Framework: Implementing CLERP 6* (Consultation Paper, March 1999) 48–50.
215 *Corporations Act 2001* (Cth) ss 992A, 992AA. Section 736 already prohibited hawking of securities.
216 Ibid pt 7.9, div 5.
217 Ibid s 912A(1)(a).
218 Commonwealth of Australia, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (n 161) 2.
219 Ibid 278.

consumer outcomes.[220] Hawking of financial products, the FSRC concluded, gave significant advantages to salespeople. In receiving an unsolicited call, consumers were

> unlikely to be armed with the information that they needed to allow them to assess critically the features of the (usually complex) product that was being offered. Without this information, the potential acquirer did not know what questions they needed to ask to test the truth of what was being said or to request the details necessary to assess the suitability of the product for their circumstances.[221]

104. Commissioner Hayne recommended a complete ban on the hawking of financial products.[222] Those prohibitions thereby addressed a range of sales misconduct identified in earlier ASIC investigations.[223]

105. The second notable intervention in sales processes is the deferred sales model for add-on insurance (discussed also in relation to product risks). In addition to assisting consumers to better understand financial products and the risks associated with them, deferred sales models have been justified on the basis that they help address 'the risk that a consumer will feel pressured to purchase [a financial product]', or that they might purchase a '[financial product] that does not meet their needs'.[224] The Deferred Sales Model ('DSM') ensures that sales conduct risks are reduced in relation to add-on insurance because a consumer has to take steps to either re-initiate contact with the seller or conclude the sale. Pressure selling at the point of sale, which ASIC had particularly identified in relation to insurance sold with motor vehicles (and to which the FSRC also referred),[225] was significantly less effective given the sale of the insurance had to occur at least four days after sale of the principal product (such as the motor vehicle). The DSM marked a major intervention in how and when certain financial products can be sold.

106. The final notable intervention into the manner in which products could be sold came through the removal of the exemption for funeral expenses policies. Commissioner Hayne emphasised that the existing exemption from regulation by Chapter 7 of the *Corporations Act* had a number of important implications, such as on licensing and general obligations. However, he particularly emphasised the impact the exemption had on sales, because it meant that funeral expenses policies could be hawked. ASIC had previously identified problems with 'the design, marketing and sales of funeral insurance', including funeral expenses policies.[226] In extending Chapter 7 to funeral expenses policies, this change brought with it various consumer protections, aimed at least in part at addressing sales conduct risks.

Sales conduct risks

107. Overall, the regulation of sales conduct risks has seen far more stability than in other areas of financial services regulation. This is in part because the general consumer protections were largely in place in 2001 and have generally proven satisfactory, even if sometimes honoured in the breach. But the targeted interventions in sales conduct recommended by the FSRC, notably in the DSM — as well as ASIC's potential to intervene in sales processes through its product intervention powers — suggest a greater willingness to regulate how financial products are sold so as to address sales conduct risks, rather than only regulating risks inherent in a product.

220 Ibid 280–2.
221 Ibid 280.
222 The ban was implemented through *Financial Sector Reform (Hayne Royal Commission Response) Act 2020* (Cth) sch 5.
223 Australian Securities and Investments Commission, *The Sale of Direct Life Insurance* (Report No 587, August 2018) 58–60.
224 ASIC, '17-255MR Banks to overhaul consumer credit insurance sales processes' (Media Release, 1 August 2017).
225 Australian Securities and Investments Commission, *Buying Add-on Insurance in Car Yards: Why It Can Be Hard to Say No* (Report No 470, February 2016) 9; Commonwealth of Australia, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (n 161) 288–9.
226 ASIC, '15-315MR ASIC report on funeral insurance highlights increasing premiums and high cancellation rates' (Media Release, 29 October 2015).

Part Four: Institutional and systemic risks

108. Australia's approach to institutional and systemic risks has changed significantly over the past twenty years. In particular, there has been a gradual increase in the intensity and sophistication of prudential regulation to reduce institutional and systemic risk, and in regulation that seeks to protect consumers from the consequences of institutional and systemic risks.

- Institutional risk refers to the risk of an individual firm failing to meet some or all of its obligations.
- Systemic risk refers to the 'risk of disruption to financial services that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy'.[227]

109. Systemic and institutional risks are closely linked, though not all institutional risks pose systemic risk. As Caruna observes, if

> a bank loses money from a risky investment, that is not systemic. But institutional failure, market seizure, infrastructure breakdown or even a sharp rise in the cost of financial services can have serious adverse implications for many other market participants. In these cases, there is a systemic dimension. It is such negative externalities and the significant spillovers to the real economy that are the essence of systemic risk and which make a case for policy intervention.[228]

110. Risk and risk management, more so than in any other area of financial regulation, sit at the heart of prudential regulation.

111. The Wallis Inquiry considered that prudential regulation was justified where information asymmetries could not be overcome. In these cases,

> it may be desirable to substitute the opinion of a third party for that of consumers themselves. In effect, the third party is expected to behave paternalistically, looking out for the best interests of consumers when they are considered incapable of doing so alone. To some extent, such third parties can be supplied by markets (such as the role played by rating agencies). However, for many years the practice in all countries has been for government prudential regulators to take on much of this role.[229]

112. As this Part demonstrates, the period from the Wallis Inquiry to the late-2010s saw significant change in the exposure of consumers to institutional and systemic risks. The Wallis Inquiry had expected consumers to take on some degree of exposure to the risk of failure by a financial institution with whom they dealt. Two trends in the past twenty years have reduced individuals' exposure to institutional risk, and the expectation that consumers will manage this risk: first, more intensive and expansive prudential regulation; and second, the introduction of financial claims schemes. These changes in regulatory philosophy have been facilitated by a more deliberately designed legislative architecture put in place following the Wallis Inquiry, characterised by a clear and consistent legislative hierarchy and demarcated regulatory responsibilities.

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227 Financial Stability Board, International Monetary Fund and Bank for International Settlements, *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations* (Report to the G-20 Finance Ministers and Central Bank Governors, October 2009) 2.

228 Jamie Caruana, 'Systemic Risk: How to Deal with It?', *Bank for International Settlements* (12 February 2010) <https://www.bis.org/publ/othp08.htm>.

229 Wallis et al (n 5) 191–2.

Early prudential regulation

113. Prudential regulation has historically focused on the financial soundness of banks, given the exposure of individual depositors to the risk of bank failure, and the role of banks in the payments system. The original *Banking Act 1945* included a regime administered by the Commonwealth Bank for the 'protection of depositors'. This allowed the Bank to exercise a range of supervisory powers over other banks.[230] These responsibilities were transferred to the newly created Reserve Bank of Australia ('RBA') in the *Banking Act 1959.* However, scholars have argued that monetary policy, rather than prudential regulation, was the principal focus of this regime. As Hogan and Sharpe observe, most Commonwealth 'depositor or investor protection was implemented through a complex set of direct controls over bank activities' rather than through what is today regarded as prudential regulation.[231] By 'excluding banks from potential high risk exposures in domestic and foreign financial markets, the need for systematic appraisal and supervision of each bank's activities did not really arise'.[232]

The challenge of non-bank financial institutions

114. The approach of the *Banking Act 1959* was institutional, focusing on the particular type of entity providing the financial service (namely an entity authorised by the *Banking Act 1959*). Non-bank financial institutions ('NBFIs') were not subject to the *Banking Act* and did not face the same regulation when they took savings, including deposits, from consumers. A patchwork of state legislation regulated building societies and credit unions, despite these institutions offering functionally similar services to banks.[233] These state regimes were generally more favourable to the NBFIs than Commonwealth regulation in respect of banks, and the 1960s and 1970s saw significant growth in NBFIs relative to banks. Commonwealth efforts to reduce these regulatory asymmetries stalled in the 1970s.[234] The growth of banks overtook that of NBFIs in the 1980s and 1990s as bank deregulation reduced the benefits of being an NBFI.[235] This deregulation followed the Campbell Inquiry in 1981, which recommended 'immediate or ultimate abandonment of a wide range of direct controls and a shift to almost total reliance on open market methods of intervention in domestic financial markets'.[236] The Inquiry identified that institutional groups

> which were of little significance forty years ago have since developed into positions of considerable importance (e.g. building societies, finance companies, credit unions and superannuation funds), whilst important new financial institutions have emerged (e.g. private savings banks, merchant banks, authorised short-term money market dealers, unit trusts and special purpose banks).[237]

115. The development of these institutions, and the different prudential regulation they faced, led the Campbell Inquiry to recommend

> a functional approach — a group of intermediaries performing a particular activity (e.g. competing for household deposits) should generally be subject to comparable monetary controls and prudential regulation, having regard to the differing characteristics of their assets and general perceptions of risk.[238]

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230 *Banking Act 1945* (Cth) pt II div 2.
231 WP Hogan and Ian G Sharpe, 'Prudential Supervision of Australian Banks' (1990) 66(2) *Economic Record* 127, 128.
232 Ibid.
233 Di Thomson and Malcolm Abbott, 'Australian Financial Prudential Supervision: An Historical View' (2000) 59(2) *Australian Journal of Public Administration* 75, 81–2.
234 Part IV of the *Financial Corporations Act 1974*, regulating 'financial corporations', never commenced.
235 Thomson and Abbott (n 233) 83.
236 Campbell et al (n 11) xxviii.
237 Ibid xxv.
238 Ibid [130].

116. Despite the Campbell Inquiry's recommendation, the institutional approach to prudential regulation persisted into the 1990s. The RBA remained reluctant to regulate NBFIs and 'cited a lack of supervisory resources, fear of a "contagion effect", and a need to maintain risk spectrum within the financial markets'.[239] The 1991 Martin Inquiry noted that the Commonwealth Government 'was not prepared to be involved in the supervision of these institutions, that they were a state responsibility and under no circumstances would it legislate to supervise these institutions'.[240] Nonetheless, in 1992, the Australian Financial Institutions Commission was created to 'develop a common regulatory standard to which individual jurisdictions would voluntarily conform' in relation to deposit-taking institutions.[241] This still left a large number of institutions facing inconsistent prudential regulation across jurisdictions, which would only be resolved following the 1996 Wallis Inquiry. This period also saw the creation of the Council of Financial Supervisors, established following a recommendation from the Martin Inquiry. Its broad objective was to 'improve communication and co-ordination among the main agencies responsible for regulation and prudential supervision in the financial system'.[242]

International developments: Basel I

117. The late-1980s saw significant developments in international cooperation on prudential regulation, with a focus on managing systemic risk as it affected the international financial system. In Australia, these changes marked the culmination of a shift away from direct controls on financial markets and banks, and a move to market-oriented and more indirect forms of prudential regulation. While aimed at systemic risk, these changes fundamentally changed the regulation of individual institutions and therefore the regulatory approach to institutional risks. This was embedded in a regulatory philosophy that did not necessarily seek to significantly reduce or eliminate risk-taking, but in which institutions were sufficiently able to manage the risks to which they were exposed.

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239 Thomson and Abbott (n 233) 85.

240 Standing Committee on Finance and Public Administration, Parliament of Australia, *A Pocket Full of Change: Banking and Deregulation* (Parliamentary Paper No 290, November 1991) 229.

241 Peter Docherty et al, Australian Prudential Regulation Before and After the Global Financial Crisis (Centre for Applied Macroeconomic Analysis Working Paper No 49/2016, August 2016) 19.

242 Graeme Thompson, *The Role of the Council of Financial Supervisors* (Speech, AFMA National Convention, Sydney, 14–15 September 1995) <https://www.rba.gov.au/speeches/1995/sp-dg-150995.html>.

Figure 3: Key concepts in modern prudential regulation

Capital adequacy requirements or standards: A bank's *capital* can be viewed in two ways, each of which is mathematically and conceptually equivalent from a balance sheet perspective: (1) the excess of its assets over its liabilities; or, (2) the amount invested by shareholders of the bank, plus its accumulated retained profits.[243] A bank's *capital ratio* refers to the ratio of its capital to its risk-weighted assets. A bank with liabilities of $92 and assets of $100 has a capital of $8 and a capital ratio of 8% ($8 ÷ $100). Capital ratios are generally risk-weighted. This means the bank or a regulator gives each asset type a risk-weighting for the purposes of determining how much capital a bank must hold against them. For example, Australian government securities are risk-weighted at 0%, and so do not count towards the bank's risk-weighted assets for the purposes of calculating the capital ratio. The risk-weighted asset value of a housing loan is 35% of its face value (eg $35 for every $100 of a housing loan), while that for a business loan is 100%.[244] Complex mathematical models are used to develop risk-weighted capital ratios, such as those prescribed by Basel III (an internationally recognised model of prudential regulation).[245] Under the Basel III requirements, the minimum total capital ratio for banks is 8%.

Liquidity requirements: A bank's liquidity refers to its stock of liquid assets. Liquid assets are those considered easy to trade or sell, particularly during periods of economic instability. Cash is the most liquid asset, followed generally by government bonds. Liquidity frameworks will designate assets that are considered liquid. For example, Basel III has a definition of a 'high-quality liquid asset' for the purposes of calculating liquidity requirements.[246]

118. As early as 1981, the Campbell Inquiry had proposed that the RBA set capital adequacy requirements for Australian banks,[247] in addition to the liquidity requirements it effectively imposed through the requirement to hold reserves with the RBA.[248] No legislative amendments were enacted to implement this recommendation, but the RBA was able to informally implement capital ratios of between 6 and 6.5 per cent through a mix of authorisation conditions and cooperation with individual institutions.[249] Capital adequacy requirements, unlike direct controls, did not necessarily seek to prevent high-risk financial activities. Instead, the requirements sought to ensure that prudentially regulated institutions, which could be sources of systemic risk, were appropriately able to manage their exposure to risk and absorb any unexpected losses.

119. Building this acceptance of risk into prudential regulation became a feature of risk-weighted capital adequacy requirements. These gained international endorsement in 1988 in the Capital Accord (Basel I). This agreement provided for a complex series of risk-weighted capital requirements for large international banks. In theory, this meant that banks held capital proportionate to the risks they were bearing. However, the regime was subject to a range of exceptions and flaws which became evident in the Global Financial Crisis. Regardless, the idea of risk-weighted capital adequacy requirements became an essential part of the prudential toolkit in Australia and internationally.

243 Australian Prudential Regulation Authority, 'Capital Explained', *APRA Insight 2020 Issue One* (2020) <www.apra.gov.au/capital-explained>.
244 Australian Prudential Regulation Authority, 'APRA Explains: Risk-Weighted Assets', *APRA Insight Issue two - 2020* (2020) <www.apra.gov.au/apra-explains-risk-weighted-assets>.
245 See, eg, Basel Committee on Banking Supervision, Bank for International Settlements, *Minimum Capital Requirements for Market Risk* (January 2019).
246 Basel Committee on Banking Supervision, Bank for International Settlements, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (January 2013) [24].
247 Campbell et al (n 11) 300–2.
248 Ibid 306.
249 Hogan and Sharpe (n 231) 133.

120. The 1980s and early-1990s also saw the RBA introduce risk management guidelines for firms, leading to 'more differentiated capital requirements which better reflect the specific risks of individual institutions'.[250] This period saw capital adequacy requirements 'introduced and tightened for non-bank deposit taking institutions', as well as enhanced for life and general insurance companies.[251]

The Wallis Inquiry and the foundations of Australian prudential regulation

121. The Campbell Inquiry noted that the institutional approach to prudential regulation, and the differing prudential standards among Australian jurisdictions, resulted in an unequal regulatory environment for institutions offering functionally similar services (and therefore posing similar risks). This disparity continued into the 1990s, despite attempts at cooperation between Australian jurisdictions and regulators. The Wallis Inquiry set out to address this, and in so doing laid the foundations for how Australia regulates systemic and institutional risks. Its proposals occurred against the backdrop of a vast and growing financial system, and an economy that could be seriously affected by developments in financial markets.

The Wallis Inquiry's regulatory philosophy

122. The Wallis Inquiry sought to develop a clear and shared understanding of the purpose and scope of prudential regulation. The Inquiry emphasised that prudential regulation should be aimed at

> financial risks [that] cannot be adequately priced or managed by the market. Some financial promises have the combined characteristics of being onerous to honour, difficult to assess, and of major adverse consequence if breached — not only for the promisee, but for third parties as well. In addition to information asymmetry, of particular concern are threats to system stability. In these areas, the financial system should be subject to a higher intensity of regulation.[252]

123. The Wallis Inquiry also positioned systemic risk, which only entered public discourse in the early- to mid-1980s, as an important focus of Australian financial regulation. However, the Inquiry was clear that regulation needed to balance the reduction of systemic and institutional risk with the fact that risk is inherent in the financial sector. Central to the Wallis Inquiry's regulatory philosophy was the need to appropriately preserve risk in financial markets, including the risk of institutional failure:

> [Not] all financial services should be subject to financial safety regulation. If regulation is pursued to the point of ensuring that promises are kept under all circumstances, the burden of honour is effectively shifted from the promisor to the regulator. All promisors would become equally risky (or risk free) in the eyes of the investing public. Regulation at this intensity removes the natural spectrum of risk that is fundamental to financial markets. If it were extended widely, the community would be collectively underwriting all financial risks through the tax system, and markets would cease to work efficiently.[253]

124. Recommendation 34 of the Wallis Inquiry reflected the tension inherent in prudential regulation: the 'intensity of prudential regulation needs to balance financial safety and efficiency'.[254] The Inquiry argued that this 'balance should preserve a spectrum of market risk and return choices for retail investors, meeting their differing needs and preferences'.[255] Efforts to manage systemic risk and financial safety should also 'minimise the adverse effects on efficiency, competition, innovation and competitive neutrality'.[256] Regulation could achieve this through disclosure, which

250 Wallis et al (n 5) 645.
251 Ibid.
252 Ibid 299.
253 Ibid 192.
254 Ibid 320.
255 Ibid 321.
256 Ibid.

would be administered by the regulator that became ASIC. Disclosure would 'promote further transparency for markets in assessing the risks posed by financial institutions' activities'.[257] Prudential regulation was to be but one piece of the puzzle for managing institutional risk.

125. Prudential regulation was also to be reserved for only some activities. The Inquiry located systemic risk, and the need for prudential regulation against institutional risks, in particular sectors of the financial system. The intensity of regulation was to vary based not only on the institution but on the attributes or economic functions of its financial products; namely, 'the characteristics of the promises which they contain' and the 'the inherent risks of the product'.[258] Prudential regulation would therefore 'be expected to combine institutional and functional coverage'.[259]

126. In particular, the Inquiry noted that 'institutions offering payments services or conducting the general business of deposit taking — including retail banks, building societies and credit unions [were] clear candidates for prudential regulation'.[260] The Inquiry also identified 'a strong case for prudentially regulating: capital backed investment products offered by life insurers and friendly societies; and risk products, including term life and general insurance products'.[261] It considered entities and activities related to the settlement of securities and derivatives to be important sources of systemic risk.[262] Managed funds, where returns may vary and declines in value could result in hardship, would not be subject to prudential regulation because such loss was 'clearly a consequence of the risk accepted by the investor'.[263] An important exception to this principle was superannuation, where prudential regulation is justified 'even where investors have knowingly accepted market risk'.[264] The willingness to regulate superannuation reflected the fact that it was mandatory and that almost all Australians were exposed to the risks of institutional failure, which could have catastrophic consequences. Nonetheless, the focus on regulating for functions represented a shift in regulatory philosophy that offered a more consistent and sophisticated understanding of how best to regulate systemic and institutional risks.

Managing systemic risk

127. The Wallis Inquiry concluded that managing systemic risk required clearer regulatory responsibilities and a clear regulatory philosophy. The Inquiry also noted that there are two main approaches to managing systemic risk: preventative measures (including prudential regulation and sustainable macroeconomic policies) and reactive strategies (including liquidity support and, where appropriate, statements of support to assuage uncertain markets).[265] Prudential regulation was therefore only one means of managing systemic risk, though a significant one.

Regulatory responsibilities

128. Core to the reform of regulatory responsibilities was the consolidation of prudential regulation in a single regulator. This involved the consolidation of regulators at both the Commonwealth and state level, which each had responsibility for particular types of institutions.[266] The new regulator, which became the Australian Prudential Regulation Authority ('APRA'), would cover deposit-taking institutions, life and general insurers, friendly societies, and providers of superannuation products and retirement savings accounts.[267] The conduct and markets regulator, which would become ASIC, would remain responsible for regulating conduct and disclosure. The RBA would

257 Ibid 336.
258 Ibid 303–5.
259 Ibid 305.
260 Ibid 304.
261 Ibid.
262 Ibid 367–370.
263 Ibid 305.
264 Ibid.
265 Ibid 364–5.
266 Ibid 302.
267 Ibid 321–334.

be responsible for system stability as a whole,[268] managing sources of systemic risk through preventative and reactive measures described above. The RBA, as it long had, would also be the key anchor and regulator of the payments system. Along with new legislation,[269] a Payments System Board was formed in the RBA,[270] which has 'responsibility for determining the Reserve Bank's payments system policy' with particular regard to 'controlling risk in the financial system'.[271] APRA and ASIC would represent a 'twin peaks' approach to regulation,[272] with the RBA sitting at the heart of the financial system through its role in the payments system and its focus on systemic stability. Following a recommendation from the Murray Inquiry,[273] these regulators would cooperate through the reworked non-statutory Council of Financial Regulators, which since 2003 has included the Department of the Treasury (Cth).[274] This regulatory architecture has proven perhaps the most resilient of all the Wallis Inquiry's proposals.

Enhancements in prudential regulation

129. The institutional architecture of the Wallis Inquiry has continued to be the foundation of Australian prudential regulation to this day. However, the balance struck between financial safety and efficiency has shifted, with more institutions and financial products subject to a higher intensity of prudential regulation. Prudential regulation, particularly over the past 10 years, has also been used as a tool for managing macroeconomic conditions that may create systemic risks. A number of legislative and regulatory developments exemplify these changes. However, before considering the changing approaches to risk in the period, it is worth examining this legislative architecture. As will be seen, a notable feature of the legislative architecture is the extent to which it has been able to adapt to significant reforms (unlike the architecture of the *Corporations Act*, as discussed in previous sections of this Paper).

The original legislative architecture

130. Following the Wallis Inquiry, a range of financial services Acts were amended to create APRA and establish the architecture for effective prudential regulation. This architecture was based on primary legislation that contained high-level provisions regulating firms such as life insurers and authorised-deposit taking institutions ('ADIs'). Detailed prudential requirements for firms would then be prescribed by APRA through 'prudential standards'.[275] Immediately following the Wallis Inquiry, this architecture was adopted in the *Banking Act 1959* and the *Life Insurance Act 1995*.[276]

131. An analogous architecture was created for private health insurers in the *National Health Act 1953* in 1999,[277] under which solvency standards and capital adequacy standards could be made. However, this Act was administered by the Private Health Insurance Administration Council rather than APRA.[278]

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268 Ibid 538.

269 *Payment Systems (Regulation) Act 1998* (Cth).

270 Wallis et al (n 5) 362.

271 Reserve Bank of Australia, 'Payments System Board', *About Us* <https://www.rba.gov.au/about-rba/boards/psb-board.html>. See also the definition of 'public interest' in s 8 of the *Payment Systems (Regulation) Act 1998* (Cth), which requires the RBA 'have regard to the desirability of payment systems … not (in its opinion) materially causing or contributing to increased risk to the financial system'.

272 For a review of the global success of the 'twin peaks' model, see Andrew Godwin and Andrew Schmulow, *The Cambridge Handbook of Twin Peaks Financial Regulation* (Cambridge University Press, 2021).

273 Murray et al (n 123) 543.

274 Treasury was included following the collapse of HIH Insurance: Council of Financial Regulators, 'History', *About* <https://www.cfr.gov.au/about/history.html>.

275 These have been classified as legislative instruments since the enactment of the *Legislative Instruments Act 2003* (Cth), renamed the *Legislation Act 2003* (Cth) in 2015.

276 Through amendments in the *Financial Sector Reform (Amendments and Transitional Provisions) Act 1998* (Cth).

277 The architecture was created through amendments in the Schedule 2 of the *Health Legislation Amendment Act (No. 3) 1999*.

278 Consideration had been given to having APRA regulate private health insurers, but this was not 'considered immediately viable' because of 'the significant differences between the general insurance and private health insurance industries (i.e. the non-risk rated nature of health insurance)': Explanatory Memorandum, Health Legislation Amendment Bill (No. 3) 1999 (Cth) 6.

132. A critically important feature of this architecture was APRA itself, which replaced multiple earlier regulators. In doing so, the architecture ensured that just one regulatory philosophy would be determinative in prudential regulation: the philosophy of APRA. The establishment of one regulator sitting at the heart of a clear legislative architecture, and acting as the single lawmaker in prudential regulation, has been a notable feature of prudential regulation in Australia. APRA's position contrasts with that of ASIC in financial services regulation, where ASIC's lawmaking function overlaps with, rather than complements, that of the Minister, regulations, and Parliament.

Immediate reforms — General insurance and banking regulation

133. Amendments in 2001 extended the prudential standards model to general insurers regulated by the *Insurance Act 1973*.[279] This Act had 'remained largely unchanged since its inception' nearly 30 years prior and was 'widely perceived to be blunt and unresponsive in the face of market developments that [had] transformed the financial sector over recent years'.[280] The Explanatory Memorandum to the *General Insurance Reform Bill 2001* (Cth) noted that prudential 'standards would replace the current highly prescriptive prudential supervisory requirements set out in the Insurance Act with more flexible, tailored and risk specific requirements for insurers'.[281] The reforms embedded risk in the regulation of general insurers, recognising that different 'types of insurance business are riskier than others' by extending a capital adequacy standard to general insurers. Firms 'would be required to hold capital commensurate with the risk profile of the insurance business underwritten', meaning that higher 'risk insurers would be required to hold higher minimum capital relative to lower risk insurers'.[282] General insurers therefore became subject to the more intensive model of prudential regulation applicable to other important prudentially regulated firms.

134. The *Banking Act 1959* was also amended in 2000 to allow APRA to give directions to ADIs in the event APRA concluded an ADI was likely to breach a prudential regulation or standard and the breach posed a prudential risk. This was an extension on earlier APRA powers only exercisable where an actual breach of a prudential regulation or standard had occurred or depositors' interests were at risk.[283] APRA also received several other powers to enhance its prudential supervision of ADIs, such as improved information-gathering powers.

135. This period also saw the collapse of Australia's second largest insurer, HIH Insurance, in 2001.[284] In the first major departure from the Wallis Inquiry's prudential regulatory philosophy, the Government implemented the HIH Claims Support Scheme. This ad-hoc intervention provided up to $640 million in compensation for policyholders. The Wallis Inquiry had been clear in its view that the Government should not guarantee financial promises. The Government's intervention indicated its willingness to protect consumers from the risks of financial collapses. In doing so, the Government undermined the Wallis Inquiry's view that the community should not expect state intervention and fostered 'community expectations of implicit government guarantees of prudentially regulated institutions'.[285] Research after the intervention suggested that 60% of respondents thought the government 'would provide at least partial compensation in the event of a failed bank'.[286] The Government's intervention is consistent with academic research suggesting that financialisation increases electoral pressure to protect consumers from institutional or systemic failure in financial markets.[287]

279 *General Insurance Reform Act 2001* (Cth).
280 Explanatory Memorandum, General Insurance Reform Bill 2001 (Cth) [1.2].
281 Ibid [3.9].
282 Ibid.
283 Revised Explanatory Memorandum, Financial Sector Legislation Amendment Bill (No. 1) 2000 (Cth) [6.2].
284 The collapse of HIH also led to significant internal reform of APRA through the *Australian Prudential Regulation Authority Amendment Act 2003* (Cth).
285 Davis (n 127) 312.
286 Ibid.
287 Chwieroth and Walter (n 26).

Shifting regulatory philosophies

136. The 2000s saw two significant developments in regulatory philosophies towards institutional and systemic risks. These were reflected in the Basel II and III reforms, which built on the major shift in regulatory philosophy represented by Basel I. APRA and the legislative architecture for prudential regulation was able to implement these reforms without creating many of the sources of legislative complexity present in Chapter 7 of the *Corporations Act* and other financial services legislation. For example, notional amendments did not form a part of these reforms, nor were the reforms implemented through the inconsistent use of different types of legal instruments by Parliament, Ministers, and APRA. Instead, the changes were overwhelmingly implemented by APRA through a limited number of instruments (prudential standards accompanied by guidance, as well as reporting standards)[288] and following significant consultation. The reforms were also subject to ongoing regulatory review as APRA developed the standards. The legislative architecture therefore adapted to major shifts in regulatory philosophy, and the major changes in the law these brought, without creating significant legislative complexity.

Basel II

137. APRA undertook major reforms to its prudential standards for ADIs in 2007 following the Basel II process and ongoing work to enhance prudential regulation of conglomerates that included ADIs.[289] Basel I had been subject to a range of criticisms since its implementation in Australia and internationally, including that its rules were not sufficiently risk-sensitive or could actually encourage excessive risk-taking.[290] APRA also noted that there had 'been substantial change in global financial markets and developments in risk measurement and management techniques'.[291] The reforms were therefore in part the product of enhanced understanding of risk and increased financialisation, including the continued development of financial instruments through securitisation and greater use of derivatives. Their adoption in Australia reflected a willingness to align with international developments, as had been the case with Basel I, which Australia was among the first to adopt.[292]

138. The purpose of Basel II was to 'promote the adoption of stronger risk management practices by the banking industry'.[293] As the APRA Explanatory Statement to its new prudential standards explained, the Basel II reforms built on the regulatory philosophy of Basel I, which had been the 'first step in moving from a simple capital-to-assets ratio to a methodology whereby banks held capital that was better aligned to risk'.[294]

139. The Basel II reforms were built around three pillars: minimum capital requirements (Pillar One), the supervisory review process (Pillar Two), and increased disclosure requirements (Pillar Three). Pillars One and Two were aimed at more intensively and sensitively regulating prudential risk in firms, while Pillar Three sought to use enhanced disclosure to increase 'market discipline' in relation to prudential risks. Pillar One, for example, offered a spectrum of more sophisticated approaches to calculating risk weights for assets and the associated capital requirements.[295] A

288 Reporting standards are made under the *Financial Sector (Collection of Data) Act 2001* (Cth).
289 This package of reforms was comprised of 11 new prudential standards for ADIs: Explanatory Statement, Banking (prudential standard) determinations Nos. 3-4, 6-8, 10-11, 13-14, 16-17 of 2007 (Cth) 1–2. APRA's reforms applied to all ADIs, though specific prudential standards applied only to ADIs that were using advanced approaches for assessing risk, and some did not apply to foreign ADIs.
290 Docherty et al (n 241) 24.
291 Explanatory Statement, Banking (prudential standard) determinations Nos. 3-4, 6-8, 10-11, 13-14, 16-17 of 2007 (Cth) 13.
292 Ibid 12.
293 Basel Committee on Banking Supervision, Bank for International Settlements, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (June 2004) [4].
294 Explanatory Statement, Banking (prudential standard) determinations Nos. 3-4, 6-8, 10-11, 13-14, 16-17 of 2007 (Cth) 12.
295 Basel Committee on Banking Supervision, Bank for International Settlements, 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework' (n 293) [6]–[7].

new capital charge was also introduced for operational risk,[296] recognising an increasing range of risks to which banks were understood to be exposed. The Pillar Three disclosure obligations were 'intended to complement broader regulatory objectives in Basel II rather than to replace them'.[297]

Compensation arrangements and retail clients

140. This period also saw the introduction of enhanced compensation arrangements for financial services licensees that were regulated by the *Corporations Act*. Introduced on July 2007, reg 7.6.02AAA of the *Corporations Regulations* required that licensees obtain professional indemnity insurance to comply with s 912B of the *Corporations Act*.[298] The regulation was intended to 'reduce the risk that compensation claims to retail clients cannot be met by the relevant licensees due to the lack of available financial resources'.[299] ASIC was clear that it would 'administer the compensation requirements to maximise their potential to reduce the risk that a retail client's losses (due to breaches by a licensee) cannot be compensated by the licensee due to the lack of financial resources, as far as this is practically possible'.[300] Again, a desire to manage risks to which consumers may be exposed, in this case counterparty risk, drove reforms in financial services regulation. However, the manner in which the reform occurred, through notional amendments to the Act to defer the commencement of s 912B and then regulations to prescribe the compensation requirements, with ASIC consulting on the administration of these requirements, presents a contrast to the way in which self-contained APRA-made prudential standards covering prescriptive matters could evolve. Legislative and broader regulatory complexity was one result of the manner in which the compensation requirements were introduced.

The Global Financial Crisis and Basel III

141. The story of the Global Financial Crisis ('GFC') has been told many times, and will not be considered extensively in this section. Suffice to say that it significantly changed regulatory philosophies towards systemic and institutional risks. A number of reports published in the immediate aftermath of the GFC identified poor risk management as a key cause of the crisis, as well as regulatory failures that resulted in, for example, insufficient bank capital and liquidity.[301] Basel III introduced 'much higher capital requirements and more risk sensitivity' for banks.[302] APRA began consulting on enhancing prudential standards in light of Basel III in 2011,[303] and APRA introduced 16 new prudential standards for banks in 2012, most of which replaced existing standards.

142. One of three objectives of APRA's reforms was to 'reduce the likelihood of the need for (and degree of) government intervention or support for ADIs in any future financial crisis',[304] reflecting APRA's intensified regulation of institutional and systemic risks and also the broadening of risk beyond financial risk to include risks such as conduct risk. The Basel III implementation process has been gradual, and APRA has been implementing different phases of the reforms (such as for disclosure and counterparty credit risks) for the past decade.[305]

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296 Docherty et al (n 241) 25.

297 Ibid 26.

298 Section 912B had been introduced in the *Financial Services Reform Act 2001* (Cth), but its commencement had been deferred to 1 July 2007.

299 Australian Government, *Compensation Arrangements for Financial Services Licensees* (Regulation Impact Statement, April 2007) 7.

300 Australian Securities and Investments Commission, *Compensation and Insurance Arrangements for AFS Licensees* (Consultation Paper No 87, July 2007) [6].

301 Docherty et al (n 241) 31–2.

302 Davis (n 127) 315.

303 Australian Prudential Regulation Authority, *Implementing Basel III Capital Reforms in Australia* (Discussion Paper, September 2011).

304 Explanatory Statement, Banking (prudential standard) determination No. 3 of 2012 (Cth).

305 See, eg, Australian Prudential Regulation Authority, 'Basel III Capital: Counterparty Credit Risk and Other Measures', *Consultations for Authorised deposit-taking institutions* (January 2013) <www.apra.gov.au/basel-iii-capital-counterparty-credit-risk-and-other-measures>; Australian Prudential Regulation Authority, 'Basel III Disclosure Requirements', *Consultations for*

143. The language surrounding these reforms underlines just how far the regulatory philosophy towards institutional and systemic risks has come. While the Wallis Inquiry considered it inevitable that some firms would fail, and thereby create systemic risks and potential consumer harm, the Murray Inquiry recommended that every effort should be made to reduce the likelihood of institutional failure, including through 'unquestionably strong' capital ratios for banks. APRA is today committed to an 'unquestionably strong financial system in the years ahead',[306] and recently consulted on reforms to create an 'Unquestionably Strong Framework for Bank Capital'.[307] The legislative architecture for prudential regulation has facilitated the ongoing development of APRA's approach to risk in banking, providing a tool in the form of prudential (and reporting) standards that has allowed for regulatory evolution without notable symptoms of legislative complexity. The consistency of the overall legislative architecture, as in the commitment to particular types of detail in prudential standards and higher-level provisions in the Act, underlines how adaptive the architecture is to the needs of the area of law (prudential regulation), as compared with the approach in respect of financial services as outlined in [148] below.

Financial Claims Scheme

144. Perhaps the biggest shift in how Australia manages systemic and institutional risk came from the introduction of the Financial Claims Scheme ('FCS') in 2008. Both the Campbell and Wallis Inquiries had resisted the introduction of government guarantees for depositors or insurance policyholders,[308] though in 1982 the ALRC suggested the introduction of a guarantee for general insurance policyholders.[309] The Wallis Inquiry was clear that the 'assurance provided by prudential regulation should not extend to a government guarantee of any financial promises'.[310] While some considered that the *Banking Act 1959* included an implicit guarantee for banks, the RBA Governor sought to dispel this in 1985, suggesting that the

> legislation is less than a guarantee to depositors of full repayment and is no assurance of the solvency of an individual bank, nor of how the parties would emerge in the event of a winding-up.[311]

145. The government promptly ignored the Wallis Inquiry's opposition to government guarantees with the launch in 2001 of the HIH Claims Support Scheme.[312] In the midst of the Global Financial Crisis, the Parliament formally abandoned the idea that the government was not in the business of guaranteeing any part of the financial system.[313] The FCS marked the first formal shift to eliminating, as opposed to managing, risk in prudential regulation. The FCS guarantees deposits of up to $250,000 per account holder per ADI.[314] It also covers claims of up to $5,000 for general insurance policyholders, and higher claims for eligible policyholders.[315] A separate regime also provides protection for private health insurance policyholders. These reforms reflect the reality that certain information asymmetries cannot be overcome (for example, relating to the prudential health of an institution) and changes in risk tolerance in depositor protections.

Sector-specific reforms in the 2010s

146. The 2010s saw a number of other reforms to prudential regulation that reflected, in part, the changing approaches to risks in financial markets. In particular, the period saw the extension of many of the regulatory standards first developed for banks to other sectors. For example, early in

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uthorised deposit-taking institutions (May 2015) <www.apra.gov.au/basel-iii-disclosure-requirements>.

306 Australian Prudential Regulation Authority, *An Unquestionably Strong Framework for Bank Capital* (Information Paper, November 2021) 5.

307 Ibid.

308 Campbell et al (n 11) [20.11], [20.37]–[20.43]; Wallis et al (n 5) 193, 300.

309 Australian Law Reform Commission, 'Insurance Contracts' (n 56) [370].

310 Wallis et al (n 5) 175.

311 R A Johnston, 'Prudential Supervision of Banks' (1985) March *RBA Bulletin* 571, 572, cited in Hogan and Sharpe (n 231) 131.

312 See discussion at [135].

313 *Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008* (Cth).

314 *Banking Act 1959* (Cth) pt II, div 2AA; *Banking Regulation 2016* (Cth) reg 11.

315 *Insurance Act 1973* (Cth) s 62ZZF; *Insurance Regulations 2002* (Cth) pt 4A.

the decade, APRA enhanced and significantly standardised the prudential regulation of general and life insurers. These changes were aimed at reducing the risk of institutional failure and improving risk sensitivity in prudential standards.[316] In 2015, the prudential regulation of private health insurers was transferred to APRA under a new Act,[317] which also harmonised the legislative architecture with others administered by APRA.[318] APRA has subsequently begun consulting on enhancing capital requirements for private health insurers, using the standards for life and general insurers as a template.[319] Amendments in 2012 also extended the APRA-administered model of prudential standards to the *Superannuation Industry (Supervision) Act 1993*.[320] This followed recommendations in the Stronger Super Review.[321] Reforms in 2012 also enhanced the regulation of derivatives markets, which became subject to a mix of ASIC and ministerial powers to improve 'transparency' and 'risk management practices'.[322] A greater desire to manage risks in financial markets was a significant driver of these reforms.

Reflecting on the legislative architecture

147. Examining prudential regulation in Australia highlights the important role that shifting approaches to systemic and institutional risks have played in driving legislative change. The Basel II and III international agreements both marked gradual shifts in the intensity of regulation applied to banks, and the approach taken to managing the sources of systemic risks they posed. The desire to more intensively manage institutional and systemic risks saw the Basel regulatory tools — such as capital adequacy and liquidity standards — extended to other sectors of the financial system. An increasing desire to more intensively manage risk, and to do so through more sophisticated tools, has therefore driven prudential regulation.

148. Exploring the history of these reforms also highlights the resilience of the architecture for prudential regulation. Despite the significance of the changes to prudential regulation discussed above, the institutional and legislative architecture in which APRA operated coped relatively well in terms of maintaining an adaptive, efficient, and navigable legislative framework, and in reducing and managing complexity. The broad outlines of the regulatory framework, with prudential and reporting standards at the core, have remained relatively stable. Sources of complexity present in Chapter 7 of the *Corporations Act* — notional amendments, hundreds of narrowly focused legislative instruments, extensive and varied regulations, overlapping responsibilities between ministers, Parliament, and regulators — have not emerged in APRA-administered legislation. The distinctive architecture of APRA's model of prudential regulation has also made it relatively easy to extend to new sectors, such as general insurance, superannuation, and private health insurance.

149. The important role of prudential standards in facilitating changed approaches to regulation is unmistakable. APRA has been able to frequently update these instruments, often following years of consultation, in response to shifting approaches to risk, while maintaining the standards as largely self-contained statements of the law (noting the potential for APRA guidance and correspondence to shape the law's interpretation by firms). APRA's ability to update its standards, and its other powers to give directions to firms, have also meant that it has not always resorted to the law. Its interventions in the residential mortgage market, for example, have often been

316 Australian Government, *Life and General Insurance Capital Review* (Regulation Impact Statement, December 2011) 12.
317 *Private Health Insurance (Prudential Supervision) Act 2015* (Cth).
318 Explanatory Memorandum, Private Health Insurance (Prudential Supervision) Bill 2015 (Cth) [1.6].
319 Australian Prudential Regulation Authority, *Review of the Private Health Insurance Capital Framework* (Information Paper, December 2021) 3.
320 *Superannuation Legislation Amendment (Trustee Obligations and Prudential Standards) Act 2012* (Cth).
321 Review of the Governance, Efficiency, Structure and Operation of Australia's Superannuation System, Attorney-General's Department, 'Super System Review' (n 99) 57 (rec 10.2).
322 Revised Explanatory Memorandum, Corporations Legislation Amendment (Derivative Transactions) Bill 2012 (Cth) [1.5].

implemented through letters to ADIs. This was the case for the introduction of caps on interest-only and investor loans,[323] which were aimed at systemic and institutional risks.[324]

150. The clear allocation of responsibilities between Parliament, the Treasury, ministers, and APRA, has also proven important in reforms to prudential regulation. Unlike Chapter 7 of the *Corporations Act*, where there are overlapping responsibilities in some areas, the clear allocation of responsibilities in the area of prudential regulation has minimised complexity. Whether or not one agrees with the particular design choices underlying the APRA model of regulation, it has the key attribute of consistency: a regulated entity generally knows who will make the rules that affect it, and where those rules are located.

323 Australian Prudential Regulation Authority, *Reinforcing Sound Residential Mortgage Lending Practices* (Letter to All Authorised Deposit-Taking Institutions, December 2014); Australian Prudential Regulation Authority, *Further Measures to Reinforce Sound Residential Mortgage Lending Practices* (Letter to All Authorised Deposit-Taking Institutions, March 2017).

324 In justifying its intervention in investor lending, APRA referred to the fact that '[f]ast or accelerating credit growth can also be a key indicator of a build-up in risk, both at an individual ADI and at an aggregate system level': Australian Prudential Regulation Authority, 'Reinforcing Sound Residential Mortgage Lending Practices' (n 323) 2.