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Bachelor of Commerce (B2001) | Level 3 • Part B Major | Monash University

Finance and society

Course Code: BFC3999 • Module 1 Notes

Module 1: Role of Finance in Society, Ethical Frameworks & Financial Misconduct

1.1 The Social Contract of Finance and Economic Intermediation

The financial system exists to serve the real economy by mobilising savings, allocating capital to productive investment, managing risk across time and contingencies, and operating reliable payment infrastructure. In classical welfare economics, well-functioning financial markets allow households to smooth consumption over the life cycle and enable enterprises to fund long-lived infrastructure, innovation, and employment without relying solely on retained earnings. Yet finance is uniquely susceptible to market failures because financial contracts are promises to deliver value in the future under conditions of uncertainty, imperfect enforceability, and asymmetric information.

The concept of a **social contract of finance** recognises that banks, superannuation funds, insurers, and capital market intermediaries operate under an explicit and implicit public licence. Explicit privileges include corporate limited liability under the *Corporations Act 2001* (Cth), privileged access to central bank settlement accounts and liquidity facilities provided by the Reserve Bank of Australia (RBA), and explicit sovereign deposit guarantees under the Financial Claims Scheme (FCS). Implicit privileges include the market perception that systemically important domestic banks will be stabilised during severe financial stress to prevent economy-wide payments collapse. In exchange for this sovereign infrastructure and backstop, society expects financial institutions to act as trustworthy stewards of household wealth, intermediate credit prudently, price risk transparently, and refrain from exploiting informational or bargaining advantages over vulnerable counterparties.

Historical Evolution of Australia's Financial Social Contract

Understanding contemporary debates in Australian banking and superannuation requires situating the sector within three structural eras. From the 1940s to the late 1970s, Australia operated a heavily regulated financial system characterised by interest-rate ceilings, quantitative lending directives, exchange controls, and statutory reserve deposit ratios. While this regime maintained financial stability, it rationed credit and reduced allocative efficiency. Following the Campbell Inquiry (1981) and the floating of the Australian dollar in 1983, Australia liberalised interest rates, licensed foreign banks, and later established universal compulsory superannuation (1992). The 1997 Wallis Inquiry subsequently created Australia's Twin Peaks regulatory architecture to balance market competition with prudential safety.

Liberalisation expanded household access to home ownership, wealth management, and capital markets, but simultaneously concentrated domestic banking assets across four major Authorised Deposit-taking Institutions (ADIs)—Commonwealth Bank of Australia (CBA), National Australia Bank (NAB), Westpac Banking Corporation, and Australia and New Zealand Banking Group (ANZ)—and fostered vertically integrated conglomerates combining retail banking, superannuation trusteeship, life insurance, and financial advice. When commercial sales targets displaced professional stewardship inside these conglomerates, the implicit social contract fractured, culminating in the 2017–2019 Royal Commission.

Core Economic Functions and Sources of Social Value

To evaluate whether a financial innovation or institutional practice strengthens or erodes societal wellbeing, analysts distinguish five foundational economic functions performed by financial intermediaries and markets:

- **Intertemporal Resource Allocation:** Channelling surplus funds from savers (such as Australian households accumulating compulsory superannuation) to productive borrowers (such as renewable energy infrastructure operators, manufacturers, and homebuyers).

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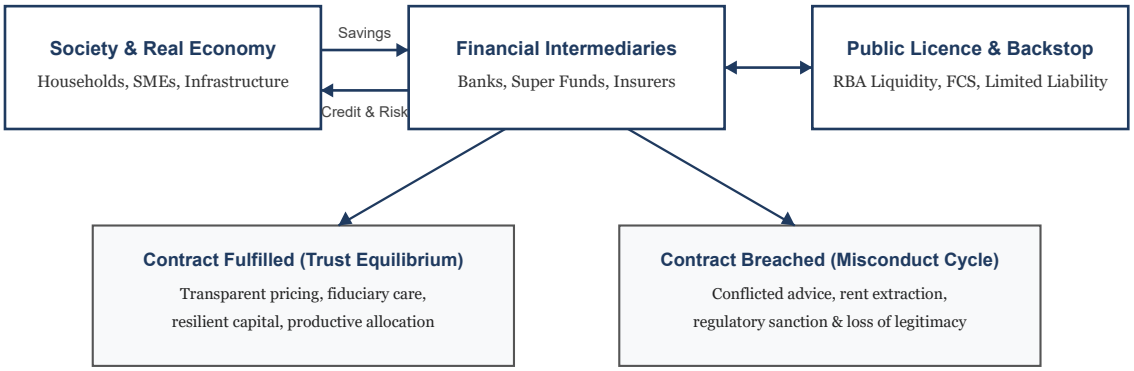
- **Maturity and Liquidity Transformation:** Funding long-term, illiquid assets (such as 30-year residential mortgages or 15-year project finance loans) with short-term, liquid liabilities (such as at-call household transaction and savings deposits).
- **Risk Pooling and Diversification:** Aggregating idiosyncratic exposures across large populations through general insurance, life insurance, and diversified managed investment schemes so individual shocks do not cause catastrophic household ruin.
- **Price Discovery and Governance Signals:** Generating forward-looking asset prices on exchanges such as the Australian Securities Exchange (ASX) that reflect cash-flow expectations, cost of capital, and managerial performance.
- **Clearing and Settlement Infrastructure:** Executing low-cost, high-integrity domestic and cross-border payments via systems such as the New Payments Platform (NPP) and RBA Reserve Information and Transfer System (RITS).

Market Failures, Externalities and Socially Excessive Finance

Empirical macroeconomic research (Arcand, Berkes and Panizza, 2015; Cecchetti and Kharroubi, 2012) demonstrates a non-monotonic, inverted-U relationship between financial sector size and real economic growth: financial deepening accelerates productivity up to a threshold, beyond which excessive private credit expansion and speculative trading divert talent from the real economy and amplify macroeconomic volatility. Four structural market failures explain why private profit maximisation in finance diverges from social welfare:

Market Failure	Economic Mechanism in Finance	Observed Societal Harm	Australian Policy Response
Information Asymmetry	Issuers and advisers hold private knowledge on fee layering, default risk, and contract exclusions (adverse selection & moral hazard).	Mis-sold complex retail products, predatory credit, and hidden commission drag on retirement balances.	Design & Distribution Obligations (DDO); Best Interests Duty (s 961B); Product Disclosure Statements (PDS).
Negative Externalities	Lenders capture private interest spreads while imposing systemic bailout risk or unpriced carbon emissions onto society.	Taxpayer crisis exposure, housing credit booms, and stranded high-emissions assets.	APRA D-SIB capital surcharges; Countercyclical Capital Buffer; mandatory AASB S2 climate disclosures.
Market Power & Rent Extraction	Oligopolistic concentration and high switching costs enable price discrimination against loyal deposit and mortgage customers.	Loyalty penalties ("back-book" mortgage rates exceeding "front-book" rates) and inflated superannuation fees.	Consumer Data Right (Open Banking); ACCC mortgage pricing inquiries; APRA MySuper performance tests.
Behavioral Exploitation	Firms design teaser rates, drip pricing, and friction-heavy opt-outs to exploit present bias and limited attention.	Chronic revolving credit-card interest, add-on insurance waste, and inertia in underperforming funds.	Product Intervention Powers (PIP); deferred sales model for add-on insurance; Your Future, Your Super stapling.

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Quantifying Social vs Private Net Return of Credit Allocation

Economic evaluation of financial intermediation compares private net present value to the institution against social net present value incorporating external costs or benefits. Let $CF_{\text{priv},t}$ denote private net cash flow earned by the lender and borrower, $E_{\text{sys},t}$ the expected systemic risk externality imposed on the deposit insurer and wider economy, and $E_{\text{env},t}$ the unpriced environmental or social externality per period over horizon T:

$$\text{NPV}_{\text{soc}} = \sum_{t=1}^{T} \frac{CF_{\text{priv},t} - E_{\text{sys},t} - E_{\text{env},t}}{(1 + r_s)^t} - I_0$$

Where:

- NPV_{soc} is the social net present value of the financed project or lending portfolio (in AUD).
- $CF_{\text{priv},t}$ is the net private cash flow generated in period t (in AUD).
- $E_{\text{sys},t}$ is the expected systemic instability or taxpayer bailout externality in period t (in AUD).
- $E_{\text{env},t}$ is the unpriced environmental or social harm (positive) or benefit (negative) in period t (in AUD).
- r_s is the social discount rate per period, and I_0 is the initial capital outlay at $t = 0$.

Worked Numerical Example: Private vs Social Lending Valuation

Suppose an Australian commercial lender evaluates two 3-year corporate credit facilities, each requiring an initial funding commitment of $I_0 = \$10{,}000{,}000$ at a social discount rate of $r_s = 6\%$. Facility A finances an unhedged, high-leverage speculative property syndicate yielding annual private net cash flows of $CF_{\text{priv},t} = \$4{,}200{,}000$, but imposing an expected systemic contagion cost of $E_{\text{sys},t} = \$350{,}000$ and community housing displacement externality of $E_{\text{env},t} = \$250{,}000$ per year. Facility B finances a regional grid-scale battery storage project yielding lower annual private cash flows of $CF_{\text{priv},t} = \$3{,}900{,}000$, zero systemic contagion cost ($E_{\text{sys},t} = \$0$), and a positive avoided-emissions social benefit of $E_{\text{env},t} = -\$300{,}000$ per year.

Step 1: Compute the 3-year annuity discount factor at $r_s = 6\%$:

$$AF_{3,6\%} = \frac{1 - (1 + 0.06)^{-3}}{0.06} = \frac{1 - 0.839619}{0.06} = 2.673012$$

Step 2: Compute private NPV for both facilities:

$$\text{NPV}_{\text{priv},A} = \$4{,}200{,}000 \times 2.673012 - \$10{,}000{,}000 = \$11{,}226{,}650 - \$10{,}000{,}000 = +\$1{,}226{,}650$$

$$\text{NPV}_{\text{priv},B} = \$3{,}900{,}000 \times 2.673012 - \$10{,}000{,}000 = \$10{,}424{,}747 - \$10{,}000{,}000 = +\$424{,}747$$

Step 3: Compute social NPV incorporating externalities:

For Facility A, net annual social cash flow is $\$4{,}200{,}000 - \$350{,}000 - \$250{,}000 = \$3{,}600{,}000$. Thus:

$$\text{NPV}_{\text{soc},A} = \$3{,}600{,}000 \times 2.673012 - \$10{,}000{,}000 = \$9{,}622{,}843 - \$10{,}000{,}000 = -\$377{,}157$$

For Facility B, net annual social cash flow is $\$3{,}900{,}000 - \$0 - (-\$300{,}000) = \$4{,}200{,}000$. Thus:

$$\text{NPV}_{\text{soc},B} = \$4{,}200{,}000 \times 2.673012 - \$10{,}000{,}000 = \$11{,}226{,}650 - \$10{,}000{,}000 = +\$1{,}226{,}650$$

Step 4: Interpretation: Based solely on private cash flows, Facility A dominates Facility B by $\$801{,}903$. Once systemic and environmental externalities are priced, Facility A destroys $\$377{,}157$ of social value while Facility B creates $\$1{,}226{,}650$. Prudential capital surcharges and carbon pricing exist precisely to internalise E_{sys} and E_{env} so private funding decisions align with social welfare.

1.2 Ethical Frameworks in Financial Decision-Making

Compliance with black-letter statute defines only the minimum floor of acceptable behaviour; ethical finance requires structured moral reasoning when rules are ambiguous, incomplete, or lagging market innovation. Three classical normative traditions—consequentialism, deontology, and virtue ethics—provide distinct lenses for resolving financial dilemmas.

Normative Ethical Traditions Applied to Finance

Consequentialism (Utilitarianism): Associated with Jeremy Bentham and John Stuart Mill, consequentialism evaluates an action solely by its net outcomes across all affected stakeholders. In corporate finance and public policy, cost-benefit analysis and Kaldor-Hicks efficiency criteria are explicitly consequentialist. However, utilitarian reasoning in finance suffers two severe vulnerabilities: it can rationalise harming a vulnerable minority (such as mis-selling complex derivatives to a small council or group of retirees) if aggregate profits appear large, and it relies on subjective probability estimates of tail harms that self-interested actors systematically underestimate.

Deontology (Duty-Based Ethics): Grounded in Immanuel Kant's categorical imperative, deontology holds that certain duties—honesty, promise-keeping, respect for autonomy, and non-exploitation—bind agents regardless of profitable consequences. Kant's second formulation (the Formula of Humanity) prohibits treating human beings merely as a means to another's end. In Australian financial law, prohibitions against misleading or deceptive conduct (*ASIC Act 2001* s 12DA) and fiduciary loyalty reflect deontological principles: a financial adviser may not fabricate a client file or conceal a kickback even if the client happens to earn a positive market return.

Virtue Ethics: Rooted in Aristotle's *Nicomachean Ethics*, virtue ethics shifts attention from isolated acts and rules to enduring moral character—integrity, courage, fairness, temperance, and practical wisdom (*phronesis*). Professional bodies such as the Chartered Financial Analyst (CFA) Institute and the Financial Advice Association Australia (FAAA) embed virtue ethics through codes requiring practitioners to place client interests above personal gain and exercise independent professional judgment even when commercial pressure rewards conformity.

Dimension	Consequentialism (Utilitarianism)	Deontology (Kantian Duty)	Virtue Ethics (Character)
Core Criterion	Maximising net aggregate wellbeing across all stakeholders	Adherence to universal moral duties and rights	Cultivating moral excellence and professional integrity
View on Client Disclosure	Disclose when transparency increases market efficiency and trust	Absolute duty not to deceive or manipulate autonomy	Honest communication is constitutive of a trustworthy adviser
Key Vulnerability	Can justify minority harm or short-term expediency	Rigid rule-following may overlook systemic trade-offs	Relies heavily on institutional culture and role models
Australian Regulatory Echo	Regulatory Impact Statements; ASIC cost-benefit mandates	Best Interests Duty (s 961B); ban on misleading conduct	CFA Code of Ethics; Hayne's six foundational norms

Behavioral Ethics, Organisational Culture and APRA's CBA Prudential Inquiry

Empirical psychology demonstrates that severe financial misconduct rarely begins with calculated criminality by sociopathic individuals; rather, it emerges incrementally within high-pressure organisational environments through predictable cognitive biases:

- **Ethical Fading:** Moral dimensions of a decision vanish from conscious awareness when decisions are framed purely in technical, legalistic, or revenue-target language (for instance, describing fee-for-no-service as "legacy system billing retention").
- **Bounded Ethicality and Moral Licensing:** Otherwise honest professionals make self-serving judgments while preserving a positive self-image, sometimes using prior charitable work or compliance training as psychological licence to cut corners on client suitability.
- **Slippery-Slope Normalisation:** Minor infractions (tweaking a risk-tolerance questionnaire slightly to fit an in-house product) go unpunished, gradually resetting group norms until systemic breaches become routine.
- **Obedience to Authority and Diffusion of Responsibility:** Junior analysts and branch staff defer to sales targets set by senior management, assuming compliance teams or legal sign-off have already validated the practice.

These behavioral dynamics were documented in APRA's landmark 2018 *Prudential Inquiry into the Commonwealth Bank of Australia*. Although CBA remained financially well-capitalised and profitable, APRA's panel diagnosed chronic failures in non-financial risk governance: widespread complacency born of financial success, a reactive and insular culture that muted dissenting risk voices, weak executive accountability for operational and conduct failures, and remuneration scorecards that overwhelmingly rewarded short-term sales growth over risk outcomes. In response, APRA mandated a $1 billion operational risk capital add-on and subsequently extended Governance, Culture, Remuneration and Accountability (GCRA) supervisory assessments across major banks, insurers, and superannuation trustees.

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Structured Ethical Reasoning and Australian Whistleblower Protections

When practitioners confront conflicted directives—such as pressure to omit adverse risk warnings from an investment memorandum or delay rectifying a known fee overcharge—professional codes recommend a sequential ethical decision protocol:

1. **Identify Facts and Stakeholders:** Separate verified empirical facts from assumptions, mapping who bears financial, legal, and reputational consequences.
2. **Clarify Legal, Fiduciary and Policy Boundaries:** Check statutory duties (such as s 961B, s 181, or insider trading prohibitions under s 1043A) and institutional compliance manuals.
3. **Apply Normative Lenses:** Test candidate actions against utility (net stakeholder welfare), duty (would this pass universalisation and publicity tests?), and virtue (does this reflect professional integrity?).
4. **Assess Institutional Barriers and Escalate:** Identify commercial or peer pressures creating ethical fading, document concerns contemporaneously, and escalate through internal risk committees or independent audit chairs.

Where internal escalation is blocked or compromised, statutory whistleblower protections provide essential institutional safety valves. Under Part 9.4AAA of the *Corporations Act 2001* (Cth) (strengthened by the *Treasury Laws Amendment (Enhancing Whistleblower Protections) Act 2019*), eligible whistleblowers—including current and former employees, contractors, and suppliers—receive enforceable anonymity protections, immunity from civil, criminal, and contractual liability for protected disclosures to ASIC, APRA, or internal eligible recipients, and civil remedies plus criminal deterrence against victimisation or retaliation. Public companies and large proprietary companies must maintain a legally compliant whistleblower policy detailing independent reporting channels.

1.3 Fiduciary Duty, Agency Conflicts & Conflicts of Interest

A **fiduciary relationship** arises whenever one party (the principal or beneficiary) reposes trust and confidence in another party (the fiduciary) who exercises discretionary power over the principal's financial interests. In equity and Australian statute, the defining obligation of a fiduciary is undivided loyalty: the fiduciary must avoid conflicts between duty and self-interest (the "no conflict" rule) and must not obtain an unauthorised profit from the fiduciary position (the "no profit" rule). Disclosure alone does not cure a conflict unless the principal gives fully informed, uncoerced consent—a standard rarely met when complex retail products are marketed to financially unsophisticated households.

Statutory Fiduciary and Consumer Protection Obligations in Australia

Australia reinforced equitable fiduciary principles through comprehensive statutory reforms across financial advice, superannuation, and retail product distribution:

- **Future of Financial Advice (FOFA) Reforms — Corporations Act 2001 (Cth) Part 7.7A:** Section 961B mandates that a personal financial adviser must act in the best interests of the client in relation to the advice. Section 961B(2) provides a seven-step statutory "safe harbour" requiring the adviser to identify client objectives, financial situation, and needs; identify the subject matter of advice; conduct reasonable investigation into financial products that might achieve those objectives; and base all judgments on the client's relevant circumstances. Section 961J requires the adviser to give priority to the client's interests whenever a conflict exists between the client's interests and those of the adviser, licensee, or related party. Division 4 prohibits **conflicted remuneration**—volume-based commissions, soft-dollar perks, or shelf-space fees from product issuers that could reasonably influence personal or general advice.
- **Superannuation Trustee Covenants — SIS Act 1993 (Cth) s 52:** Superannuation trustees are statutory fiduciaries bound to exercise care, skill, and diligence, and to perform their duties and exercise their powers in the *best financial interests* of beneficiaries (strengthened under the *Your Future, Your Super* reforms of 2021,

which also shifted the evidentiary burden onto trustees to justify expenditure). Trustees must also satisfy the sole purpose test (s 62), ensuring funds are maintained solely to provide retirement benefits.

- **Design and Distribution Obligations (DDO) — Part 7.8A:** Effective October 2021, issuers and distributors of retail financial products must prepare a Target Market Determination (TMD) defining the class of consumers for whom the product's key attributes are likely to be consistent with their objectives, financial situation, and needs, shifting accountability upstream from point-of-sale disclaimers to product governance.
- **Product Intervention Power (PIP) — Part 7.9A:** Empowers ASIC to ban or impose structural conditions on financial and credit products that have resulted in, or are likely to result in, significant consumer detriment—exercised against high-leverage Contracts for Difference (CFDs), binary options, and predatory short-term credit models.

Principal-Agent Economics and Conflicted Fee Erosion

In standard agency theory (Jensen and Meckling, 1976), an agent acting on behalf of a principal incurs **agency costs** consisting of monitoring expenditures by the principal, bonding expenditures by the agent, and residual welfare loss when the agent's actions diverge from the principal's optimum. In retail wealth management, vertical integration—where a major financial group simultaneously manufactures superannuation or investment products and employs advisers to distribute them—creates structural conflicts because product margins accrue to the parent group even when lower-cost external index funds would serve the client better.

Consider a client investing initial superannuation capital W_0 over T years earning a gross annual market return g. Under independent fiduciary advice charging a transparent upfront or flat fee F_0 with low-cost passive funds charging total annual expense ratio c_{ind}, terminal wealth is W_{fid}. Under conflicted advice steering the client into an in-house platform charging total annual asset-based fees and embedded trail commissions $c_{\text{conf}} = c_{\text{ind}} + \tau$ (where τ is the conflicted fee spread), terminal wealth W_{conf} compounds at a lower net rate:

$$W_{\text{conf}} = W_0 \left(1 + g - c_{\text{ind}} - \tau\right)^T$$

Where:

- W_{conf} is terminal portfolio wealth under the conflicted asset-based fee structure (in AUD).
- W_0 is initial invested capital at $t = 0$ (in AUD).
- g is the expected gross annual portfolio return before fees (as a decimal).
- c_{ind} is the baseline annual management expense ratio of an equivalent low-cost product.
- τ is the excess annual conflicted fee / commission spread extracted via conflicted product selection.
- T is the investment compounding horizon in years.

Worked Numerical Example: Long-Horizon Compounding Cost of Conflicted Advice

An Australian investor aged 35 holds $W_0 = \$200{,}000$ in superannuation and retires at age 65 ($T = 30$ years), assuming no additional contributions to isolate fee drag. Expected gross nominal return is $g = 7.50\%$ p.a. Option 1 (independent fiduciary advice) places the client in a diversified balanced index portfolio with $c_{\text{ind}} = 0.25\%$ p.a. and a one-off upfront fee-for-service advice charge of $\$4{,}000$ deducted at $t = 0$ (so net invested capital is $\$196{,}000$). Option 2 (conflicted advice) steers the client into an in-house active platform with no upfront fee but an annual fee of $c_{\text{conf}} = 1.45\%$ p.a. (so $\tau = 1.20\%$ excess spread).

Step 1: Compute net annual compounding rates:

- Fiduciary Option 1 net rate: $r_1 = 0.0750 - 0.0025 = 0.0725$ (7.25% p.a.)
- Conflicted Option 2 net rate: $r_2 = 0.0750 - 0.0145 = 0.0605$ (6.05% p.a.)

Step 2: Compute terminal wealth at year 30:

$$W_1 = \$196{,}000 \times (1.0725)^{30} = \$196{,}000 \times 8.16565 = \$1{,}600{,}467$$

$$W_2 = \$200{,}000 \times (1.0605)^{30} = \$200{,}000 \times 5.82353 = \$1{,}164{,}706$$

Step 3: Quantify client wealth destruction and effective fee-drag ratio:

$$\Delta W = W_1 - W_2 = \$1{,}600{,}467 - \$1{,}164{,}706 = \$435{,}761$$

$$\text{Wealth Erosion Share} = \frac{\$435{,}761}{\$1{,}600{,}467} = 27.23\%$$

Despite avoiding a $\$4{,}000$ upfront fee, the client suffers a $\$435{,}761$ reduction in retirement wealth—more than 27% of potential terminal savings—demonstrating why asset-based conflicted remuneration creates severe principal-agent wealth transfers over long horizons.

Managing vs Eliminating Conflicts of Interest

Regulation distinguishes three responses to conflicts of interest: disclosure, structural management (information barriers or "Chinese walls"), and outright prohibition. While investment banks rely heavily on information barriers to separate corporate advisory teams from equity research and proprietary trading desks, empirical evidence shows that disclosure alone often backfires in retail advice: "moral licensing" causes advisers to give more biased advice once a conflict is disclosed, while consumers either ignore fine-print warnings or interpret disclosure as a mark of candour ("panacea bias"). Consequently, post-FOFA and post-Hayne Australian regulation increasingly favours structural elimination of conflicted incentives over mere disclosure.

1.4 The Hayne Royal Commission into Financial Misconduct

Established in December 2017 and chaired by former High Court Justice Kenneth Hayne AC KC, the **Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry** delivered its Final Report in February 2019. Over 68 days of public hearings and more than 10,000 public submissions, the Commission uncovered systemic misconduct across Australia's largest banks, wealth managers, superannuation trustees, and insurers.

Root Causes Identified by Commissioner Hayne

Commissioner Hayne concluded that pervasive misconduct was not caused by isolated "bad apples" nor by insufficient complexity in statutory drafting. Instead, the primary driver was the **pursuit of short-term profit at the expense of basic standards of honesty**, amplified by four structural failures:

1. **Asymmetry of Power and Information:** Financial entities possessed decisive legal, informational, and bargaining superiority over retail consumers, farmers, and small businesses.

2. **Incentive and Remuneration Structures:** Variable pay, sales volume bonuses, mortgage broker trail commissions, and grandfathered advice commissions rewarded quantity of sales rather than client suitability or compliance.
3. **Vertical Integration and Conflicted Intermediaries:** Institutions claimed that tied advisers and mortgage brokers acted in customers' interests while simultaneously paying them to distribute proprietary products.
4. **Ineffective Regulatory Deterrence:** Regulators—particularly ASIC—frequently relied on negotiated enforceable undertakings and confidential settlements rather than litigating breaches in open court, leaving entities treating penalties as a minor cost of doing business.

Six Foundational Norms and Landmark Case Studies

Rather than proposing yet another layer of technical exceptions that licensees might game, Commissioner Hayne distilled existing law into six simple ethical and legal norms that every financial entity must internalise:

- **Norm 1:** Obey the law.
- **Norm 2:** Do not mislead or deceive.
- **Norm 3:** Act fairly.
- **Norm 4:** Provide services that are fit for purpose.
- **Norm 5:** Deliver services with reasonable care and skill.
- **Norm 6:** When acting for another, act in the best interests of that other.

Several flagship misconduct episodes exposed during the hearings reshaped Australian financial regulation and corporate governance:

- **Fees for No Service (AMP, CBA, NAB, Westpac, ANZ):** Wealth management licensees systematically deducted ongoing advice fees from client accounts—including accounts belonging to deceased estates—for years after clients ceased receiving any financial advice. Remediation across major institutions ultimately exceeded A$5 billion, triggering senior executive resignations and board overhauls.
- **Grandfathered Commissions and Superannuation Default Misuse:** Trustees and licensees retained pre-2013 conflicted trail commissions and delayed transferring members out of high-fee legacy retail funds into lower-fee MySuper accounts so parent banking groups could preserve fee revenue, violating the statutory duty to act in members' best interests.
- **Responsible Lending and Household Expense Benchmarks:** Lenders relied mechanically on the Household Expenditure Measure (HEM) poverty-line proxy rather than verifying actual borrower expenses, raising legal disputes over the boundary between prudent credit risk underwriting and consumer protection under the *National Consumer Credit Protection Act 2009* (Cth).
- **Add-On Insurance and Aboriginal Community Exploitation:** Car dealerships sold low-value add-on consumer credit insurance to low-income buyers, while funeral insurance providers (notably Youpla / Aboriginal Community Benefit Fund) targeted First Nations communities with escalating premiums and opaque exclusions that eroded policy value far beyond payouts, prompting federal government intervention and a formal remediation scheme.
- **Agricultural Lending and Foreclosure Conduct:** Major lenders enforced aggressive penalty interest rates and receiver appointments on drought-affected regional borrowers after acquiring distressed rural loan books, prompting expansion of farm debt mediation and stronger Banking Code of Practice protections.

Post-Hayne Legislative Architecture

Between 2019 and 2024, Parliament enacted the vast majority of the Commission's 76 recommendations across advice, credit, superannuation, insurance, and executive accountability:

Reform Measure	Statutory Instrument	Core Governance & Consumer Protection Mechanism
Ending Grandfathered Commissions	*Treasury Laws Amendment (Ending Grandfathered Conflicted Remuneration) Act 2019*	Eliminated pre-FOFA legacy commissions from 1 January 2021 and required direct rebates to affected clients.
Financial Accountability Regime (FAR)	*Financial Accountability Regime Act 2023* (Cth)	Expanded BEAR from banks to insurers and super trustees; mandates individual accountability statements, variable pay deferral (40%+), and disqualification powers jointly run by APRA & ASIC.
Strengthened Breach Reporting	*Corporations Act 2001* s 912DAA	Replaced subjective "significance" tests with strict objective triggers requiring AFS and credit licensees to report reportable situations to ASIC within 30 days.
Mortgage Broker Best Interests Duty	*NCCP Act 2009* Part 3-5A	Requires mortgage brokers to act in the best interests of consumers and prioritise consumer interests over broker or lender incentives.
Deferred Sales Model for Add-On Insurance	*ASIC Act 2001* ss 12DO–12DZA	Imposes a mandatory 4-day pause between sale of a primary product (e.g., motor vehicle) and offering add-on insurance to prevent pressure selling.
Compensation Scheme of Last Resort (CSLR)	*Treasury Laws Amendment (CSLR) Act 2023*	Industry-funded safety net compensating up to $150,000 for unpaid AFCA determinations involving insolvent advice or credit firms.

Financial Accountability Regime (FAR) in Practice

Originally introduced for ADIs in 2018 as the Banking Executive Accountability Regime (BEAR) and extended under FAR in 2024–2025 to general/life insurers and Registrable Superannuation Entity (RSE) licensees, FAR personalises corporate compliance. Under FAR, designated **Accountable Persons**—board directors, Chief Executive Officers, Chief Risk Officers, Chief Financial Officers, and heads of compliance or technology—must register formal Accountability Statements and an entity-wide Accountability Map with APRA and ASIC. Accountable Persons owe non-delegable statutory obligations to act with honesty and integrity, exercise due skill, care, and diligence, deal openly with regulators, and take reasonable steps to prevent matters from arising that adversely affect prudential standing or breach conduct laws. When systemic failures occur, FAR requires mandatory deferral of at least 40% of variable remuneration (for four years or longer) and empowers regulators to impose variable pay reductions or disqualify executives regardless of whether the institution paid a corporate fine.

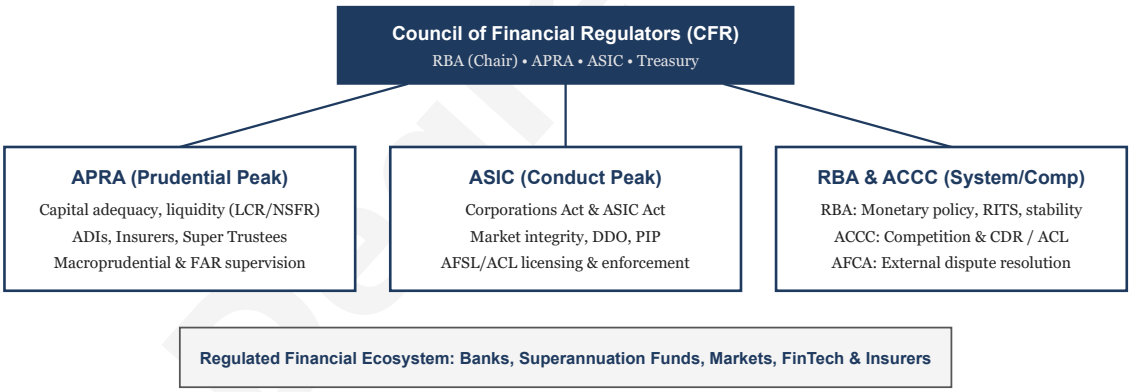
1.5 Australian Twin Peaks Regulation: ASIC, APRA & RBA

Following the 1997 Wallis Inquiry, Australia pioneered the **Twin Peaks** model of financial regulation, separating prudential supervision from market conduct and consumer protection across two dedicated statutory authorities rather than consolidating all powers in one mega-regulator (such as the pre-2013 UK FSA) or fragmenting supervision by industry silo (such as the US multi-agency model). Comparative regulatory scholarship credits Twin Peaks with minimising mission conflict—ensuring that consumer enforcement is never quietly suppressed out of fear of destabilising a bank's solvency reputation, while preserving specialist prudential focus on capital and liquidity.

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Division of Mandates Across Australian Regulators

- **Australian Prudential Regulation Authority (APRA):** The prudential peak under the *APRA Act 1998* (Cth). APRA supervises Authorised Deposit-taking Institutions (ADIs—banks, building societies, credit unions), general and life insurers, private health insurers, and registrable superannuation entities (RSEs). Its statutory mandate balances financial safety and efficiency, competition, contestability, and competitive neutrality while promoting financial system stability.
- **Australian Securities and Investments Commission (ASIC):** The conduct and market integrity peak under the *ASIC Act 2001* (Cth) and *Corporations Act 2001* (Cth). ASIC regulates corporate governance, financial markets (such as ASX and Cboe Australia), financial services licensees (AFSL), credit licensees (ACL), auditors, and misleading or deceptive conduct (s 12DA) or unconscionable conduct (s 12CB) across financial products and services.
- **Reserve Bank of Australia (RBA):** Responsible for monetary policy, overall financial system stability (via the Payments System Board and semi-annual *Financial Stability Review*), lender-of-last-resort liquidity support, and oversight of clearing and settlement facilities alongside ASIC.
- **Australian Competition and Consumer Commission (ACCC):** Enforces competition policy, merger clearances, the Consumer Data Right (Open Banking), and economy-wide Australian Consumer Law protections (with ASIC holding mirror consumer protection provisions for financial services).
- **Council of Financial Regulators (CFR):** A non-statutory coordinating body comprising the RBA (Chair), APRA, ASIC, and the Australian Treasury that aligns macroprudential policy, crisis preparedness, and cross-cutting risks such as cyber resilience, digital assets, and climate disclosures.
- **Australian Financial Complaints Authority (AFCA):** The single statutory external dispute resolution (EDR) ombudsman providing free, binding redress for consumers and small businesses up to statutory compensation caps on fairness-based as well as legal principles, without requiring costly court litigation.



Responsive Regulation, Industry Codes and the Economics of Deterrence

Ayres and Braithwaite's (1992) **responsive regulation** framework conceptualises supervision as an enforcement pyramid: regulators begin at the base with guidance, moral suasion, and supervisory reviews, escalating through infringement notices, court-enforceable undertakings, and licence conditions to civil pecuniary penalties, executive banning orders, and criminal prosecution at the apex. Post-Hayne, ASIC adopted a "why not litigate?" enforcement posture because over-reliance on cooperative settlements undermined credible deterrence and left victims without public judicial vindication. Self-regulatory industry instruments—most notably the Australian Banking Association's *Banking Code of Practice* (approved by ASIC under s 1101A)—complement statutory enforcement by creating contractually binding commitments on banks regarding vulnerable customers, guarantor protections, and basic fee-free accounts.

Under Becker's (1968) economic theory of optimal deterrence, a rational profit-maximising firm is deterred from misconduct only when the expected sanction exceeds the expected private gain from breaching the law, adjusted for the probability of detection and successful prosecution:

$$E[\text{Cost}] = p_d \cdot p_c \cdot (S + R) \geq G$$

Where:

- $E[\text{Cost}]$ is the ex-ante expected financial cost of misconduct to the institution (in AUD).
- p_d is the probability that the misconduct is detected by regulators, whistleblowers, or mandatory breach reporting.
- p_c is the conditional probability of successful enforcement and court sanction given detection.
- S is the statutory civil or criminal pecuniary penalty plus reputational/disgorgement losses (in AUD).
- R is customer remediation and legal compliance restitution costs (in AUD).
- G is the expected illicit private profit or fee revenue gained from the misconduct (in AUD).

Worked Numerical Example: Post-2019 Australian Civil Penalty Deterrence

Under the *Treasury Laws Amendment (Strengthening Corporate and Financial Sector Penalties) Act 2019* (Cth), maximum civil penalties for bodies corporate under the *Corporations Act 2001* were raised to the greatest of: (a) 50,000 penalty units, (b) three times the benefit derived and detriment avoided, or (c) 10% of annual turnover (capped at 2.5 million penalty units). Consider a wealth licensee considering retaining unlawful fees yielding an illicit gain of $G = \$18{,}000{,}000$. Suppose mandatory breach reporting and whistleblower protections set detection probability at $p_d = 0.60$, and ASIC litigation success probability is $p_c = 0.80$. Suppose customer remediation equals full restitution $R = \$18{,}000{,}000$ and the statutory penalty applied by the Federal Court equals the "three times benefit" limb: $S = 3 \times \$18{,}000{,}000 = \$54{,}000{,}000$.

Step 1: Compute joint enforcement probability:

$$p_{\text{enf}} = p_d \times p_c = 0.60 \times 0.80 = 0.48\ (48\%)$$

Step 2: Compare pre-2019 cap vs post-2019 statutory penalty:

Prior to 2019, many civil penalties were capped at roughly $\$1{,}050{,}000$ per contravention. Even with full restitution $R = \$18{,}000{,}000$, expected cost was:

$$E[\text{Cost}]_{\text{pre}} = 0.48 \times (\$1{,}050{,}000 + \$18{,}000{,}000) = \$9{,}144{,}000 < \$18{,}000{,}000$$

Because $\$9{,}144{,}000 < \$18{,}000{,}000$, an amoral profit-maximiser had a positive expected net value of $+\$8{,}856{,}000$ from committing the breach.

Step 3: Evaluate post-2019 deterrence under the $3\times$ benefit rule:

$$E[\text{Cost}]_{\text{post}} = 0.48 \times (\$54{,}000{,}000 + \$18{,}000{,}000) = 0.48 \times \$72{,}000{,}000 = \$34{,}560{,}000$$

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Since $\$34{,}560{,}000 > \$18{,}000{,}000$, the expected net present value of misconduct turns decisively negative ($-\$16{,}560{,}000$). When combined with individual accountability under FAR (which prevents executives from externalising penalties onto diversified shareholders), deterrence aligns managerial incentives with legal and ethical compliance.

Rebuilding Societal Trust: Metrics and Ongoing Challenges

Even with stronger statutory penalties, public trust in finance remains fragile because misconduct costs fall asymmetrically on ordinary households while gains accrue immediately to short-term bonus pools. Restoring the social contract requires three complementary pillars: transparent non-financial risk metrics reported alongside return on equity, independent board oversight backed by enforceable whistleblower channels, and continuous regulatory scrutiny of emerging business models—including algorithmic pricing, digital advice, and private credit—before harm scales across the Australian financial system.

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