Financial Services Council.
Growing and protecting the wealth of New Zealanders

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7 June 2019

Financial Markets Policy
Building, Resources and Markets
Ministry of Business, Innovation & Employment
PO Box 1473
Wellington 6140
New Zealand

By email: FinancialConduct@mbie.govt.nz

Submission: Conduct of Financial Institutions options paper

This submission is from the Financial Services Council of New Zealand Incorporated (**FSC**).

The FSC is a non-profit member organisation and the voice of the Financial Services sector in New Zealand. Our 35 members comprise 95% of the life insurance market in New Zealand, and manage funds of more than $47.5bn. Members include the major insurers in life, disability and income insurance, fund managers, KiwiSaver, professional services and technology providers to the Financial Services sector.

Our submission has been developed through consultation with FSC members, and represents the views of our members and our industry. We acknowledge the time and input of our members in contributing to this submission.

The FSC's guiding vision is to be the voice of New Zealand's financial services industry and we strongly support initiatives that are designed to deliver:

1. Strong and sustainable consumer outcomes;
2. Sustainability of the financial services sector; and
3. Increasing professionalism and trust of the industry.

We support the high-level outcome sought (ensuring that conduct and culture in the financial services sector is delivering good outcomes for customers), and our response highlights areas of potential 'quick wins' where Government and industry can work together to achieve this outcome.

However, we believe that more thoughtful consideration of the options will deliver better long-term outcomes for all. In our opinion, it is more important to design and implement effective, sustainable, change that works well with existing laws than to fast-track actions that may have unintended consequences.

As discussed, we look forward to continued conversation with MBIE to ensure the creation of fit-for-purpose outcomes for customers, industry and the economy.

I can be contacted on 021 0233 5414 or richard.klipin@fsc.org.nz to discuss any element of our submission.

Yours sincerely

Richard Klipin
Chief Executive Officer

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Executive summary

The scale and pace of change in the financial services industry is intense.

The past three years have seen an increasing volume of legislative, regulatory and industry activity both at home and abroad. The activity runs the gamut from the Financial Services Legislation Amendment Act (**FSLAA**) and its enactment through a raft of regulatory thematic reviews, the Australian Royal Commission enquiry and reports, and the development and implementation of the FSC Code of Conduct. All parts of the financial services sector remain in change.

Within this environment of changing laws and regulations, we continue to see a potential lack of trust as an issue. At the same time, we see the rise of consumers and consumerism. On a positive note, New Zealand continue to rank as one of the most trusted and least corrupt countries in the world.

Financial Services in New Zealand
The contribution of the broader Financial Services industry to the New Zealand economy is significant and is evolving through innovation and technology. We see our contribution in the industry as sustainably growing and protecting the wealth of New Zealanders and by promoting the wealth management sector on the global stage.

Financial services are valuable to New Zealand in many different ways. The financial services sector is the second fastest growing and third largest contributor to economic growth in New Zealand over the past 40 years (contributing $13.5bn to GDP in 2017). The sector is highly skilled, diverse and is future focussed. The sector helps New Zealanders get on with their everyday lives, covering risk and helping them save for their futures.

The data in our 2018 'Towards Prosperity' report further demonstrates how the industry enables other New Zealand industries to prosper, the importance of diversification and how we measure against the rest of the New Zealand workplace as employers.

Good policy and regulations are the responsibility of all market participants, and active engagement between the Government, the regulator(s) and industry bodies will drive good outcomes for all. Regulators' reports (both in New Zealand and Australia) have clearly indicated there is room for improvement.

FSC members have listened and understood the regulators' messages and have been actively working together to create a blueprint for the future that should build a sustainable financial services industry delivering good outcomes for customers. We also recognise that good things take time, and there is a fine balance of moving fast, yet doing things right. We caution putting haste above careful consideration.

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FSC Code of Conduct
The FSC Code of Conduct became effective 1 January 2019.

The FSC Code of Conduct is designed to increase trust and confidence in the providers of financial services and the products they deliver. This in turn will help more New Zealanders grow, manage and protect their wealth. All members of the FSC must comply with the FSC Code of Conduct.

The FSC monitors implementation of, and compliance with, the FSC Code through information requests, media scans and member reporting. Compliance with the FSC Code is a condition of FSC membership.

Enforcement of the FSC Code is through the Code Disciplinary Committee. Comprised of six expert individuals (including legal experts, code and conduct experts, industry experts) the Code Disciplinary Committee reviews all potential material breaches of the FSC Code and recommends sanctions. Sanctions can include fines, reprimands, reparation orders, suspension or termination of FSC membership.

Educational tools and resources were provided to FSC members after the launch in September 2018, with more than 2,500 employees of FSC members being trained between October 2018 and February 2019.

Work developing additional guidance for each Code Standard began in March 2019. Known as the 'Industry Blueprint' this work addresses nine key themes coming out of the regulatory insights both in New Zealand and Australia, namely:

- Complaint definition, systems and processes, remediation
- Replacement business definition and process
- Role of advice, and responsibility of product providers for intermediaries
- Vulnerable customers
- Remuneration and conflicted conduct
- Product development, definitions and upgrades, lifecycle management
- Customer communications, 'social licence to operate'
- Code enforceability
- Board and executive accountability

The FSC is a willing partner for change. The best practice work currently underway shows the focus and attention we have to creating a better future for the industry and New Zealanders. While the Government sets legislation and the regulators set regulations and monitor compliance, it is the role of the industry to own and drive cultural change. We are committed to making a difference.

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Key Strategic Themes

We highlight four broad areas where focussed attention will deliver good outcomes for customers, making a positive impact on conduct and culture in the financial services industry.

Theme One – 'Treat customers fairly'

Treating customers fairly is a consistently recognised concept, used in international best practice, the IAIS Insurance Core Principles (ICP 19), UK law, the Code of Professional Conduct for Financial Advice Services, the Code of Banking Practice and the FSC Code of Conduct.

We recommend that a duty to 'treat customers fairly' (or equivalent), rather than a duty to 'prioritise the customer's interest', would more clearly achieve similar aims, maximise consistency with other laws and codes, and minimise confusion.

A 'treat customers fairly' duty would ideally be supported by commentary, akin to the approach taken in Code Standard 1 of the Code of Professional Conduct for Financial Advice Services. In particular, our members recommend converting the 'customer outcome' options (in the options paper) into commentary for the 'treat customers fairly' duty, because that approach would:

- avoid the use of 'good customer outcome', which risks being a highly subjective test
- avoid potential conflict between the Companies Act duty to act in the best interests of the company and duties to prioritise the customer's interest or duties aimed at promoting good customer outcomes
- in insurance situations, avoid potential conflict between ensuring good customer outcomes for the individual insured and for the aggregate interests of all insureds.

Theme Two – Shared responsibility model for oversight of intermediaries

We acknowledge that the arrangements between the product provider and the intermediary are to be determined between the parties. However, we consider that regulation which enforces the need for intermediaries to demonstrate to providers that they are delivering good customer outcomes is essential to support the objectives of the conduct regime.

Any such regulation should be sufficiently flexible for conduct objectives to be achieved by considering customers generically where appropriate. For example, the manufacturer might focus generically on identifying the intended audience for a product and communicate that to distributors and intermediaries, while the intermediary by contrast would have regard to the suitability of the product for a particular customer. The alternative, requiring product providers to have an individual client focus, risks creating a regime where (to construct an extreme example) product providers may feel obliged to do file reviews of their distributors, and to second-guess intermediary's compliance, which is neither workable nor aligned with the purposes of the FMC Act.

The FSC Industry Blueprint proposes a shared responsibility model for industry oversight of intermediaries. We would welcome the opportunity to discuss the model with you.

Theme Three – Self-regulation by industry bodies

The industry body landscape has changed significantly in the last two years, not least as a result of the focus on financial services conduct and culture. FSC members are committed to ensuring that industry is 'doing

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the right thing'. Since the FSC Code of Conduct became effective on 1 January 2019, FSC members have worked together to create additional guidance on many of the key themes this review seeks to address. The FSC Industry Blueprint is currently being reviewed and tested.

There are increasing opportunities for the regulator and industry bodies to work in partnership, in ways that will ensure good outcomes for customers. While this does not have to involve formal recognition of self-regulation in conduct legislation, there should be sufficient flexibility in the regime for the FMA to foster some degree of self-regulatory accountability by the industry.

Theme Four – A level playing field for all market participants

To ensure good outcomes for customers engaging with the financial services industry, it is important that all market participants are subject to the same expectations and obligations in respect of comparable activity.

We acknowledge that some market participants are already subject to conduct obligations under existing legislation and/or regulation. In our view, the first step should be an analysis of how existing obligations currently apply to each industry segment (for example, manufacturers, distributors, managers, investment products, insurance products and other financial products). The next step would be a review of how existing obligations would change under any proposed amendments such as extending a fuller conduct regime to all industry participants.

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Detailed responses to consultation questions

1. **Which overarching duties should and should not be included in the regime? Are there other duties that should be considered? Do you agree with the pros and cons of each duty? Do you have any estimates of the size of the costs and benefits of these options? Are there other impacts that are not identified?**

QUICK WIN
Much of this is a potential quick win area and we can work with you to help settle this aspect of the regime as a priority.

At a conceptual level, our members support the overarching duties.

We recommend the precise wording of the duties be workshopped in conjunction with industry. Points to be addressed include, for example:

- Ensure the duties do not conflict – or overlap in a way that causes confusion or uncertainty – with each other and with obligations existing in other legislation or in licensing regimes.
- Consider the likely complexity and uncertainty of a duty to prioritise the customer's interest, especially in insurance situations where an individual customer's interest and all customers' interests might well conflict (see further comments below re 'treat customers fairly').
- Align (with existing regulatory obligations) the conflicts management duty proposed in option 5, particularly if it is general, rather than remuneration specific.
- Assess the interaction between option 4 and the Insurance (Prudential Supervision) Act.
- Develop transitional arrangements for implementation, including time for updating processes, systems and training.

We recommend that a duty to 'treat customers fairly' (or equivalent), rather than a duty to 'prioritise the customer's interest', would more clearly achieve similar aims, maximise consistency with other laws and codes, and minimise confusion.

A principles-based duty of this nature would ideally be supported by non-limiting commentary, akin to the approach taken in Code Standard 1 of the Code of Professional Conduct for Financial Advice Services. In particular, our members recommend converting the 'customer outcome' options[1] into commentary for the 'treat customers fairly' duty, because that approach would:

- avoid the use of 'good customer outcome', which risks being a highly subjective test
- avoid potential conflict between the Companies Act duty to act in the best interests of the company and duties to prioritise the customer's interest or aimed at promoting good customer outcomes
- in insurance situations, avoid potential conflict between ensuring good customer outcomes for the individual insured and for the aggregate interests of all insureds.

The additional guidance being developed for the FSC Code of Conduct could be a useful starting point for the workshop and development of any expectations.

Conduct regulation should be sufficiently flexible for its objectives to be achieved by considering customers generically, where appropriate. For example, the manufacturer might focus generically on identifying the

[1] For example: options [3.4] 1 and 5, [3.3] 3 and [3.5] 1 in the options paper

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intended audience for a product and communicate that to distributors and intermediaries, while the intermediary by contrast would have regard to the suitability of the product for a particular customer. The alternative, requiring product providers to have, an individual client focus, risks creating a regime where (to construct an extreme example) product providers may feel obliged to do file reviews of their distributors, and to second-guess intermediary's compliance with FSLAA, which is neither workable nor aligned with the purposes of the FMC Act.

2. **Do you think the overarching duty for managing conflicts of interest should be general (as it is currently worded) or focus on conflicts of interest that arise through remuneration? What are some examples of conflicts of interest that arise outside of conflicted remuneration and incentives?**

Our members support the conflicts management duty.

The precise form of the conflicts duty should be reassessed once there is greater certainty regarding the other duties. The nature of those other duties will influence where conflicts arise and whether a conflicts duty should be general or remuneration specific. For example, if a product provider's accountability for good customer outcomes extends beyond high level oversight, potentially complex inherent conflicts arise.

To the extent that the duty is intended to ensure there are conflicts management arrangements in place, we recommend that process element be left to existing regulatory licensing, rather than formulated as a duty. That would provide flexibility to ensure the arrangements were proportionate to the nature of business of the licensed entity.

3. **Is a code of practice required to provide greater certainty about what each overarching duty means in practice?**

Please see the comments at question 1 suggesting commentary to support an overarching 'treat customers fairly' (or similar) duty. This could be a formal part of the regime, providing information about the intent of the duty (but not guidance on how to comply with it which would undermine a principles-based approach).

Most of our members support the use of codes of practice. Those who do not, cite the cost of developing and implementing multiple codes and sources of guidance.

The FSC Code, approved in May 2018 and in force since 1 January 2019, is designed to increase customers' trust and confidence in the conduct of financial service providers and in their products. More than 2,500 FSC member employees have received training on the code. Work to develop guidance for each code standard commenced in March 2019.

Our members recommend that code development, if needed, should happen at an industry level, in close liaison with the FMA. This work should leverage existing industry Codes, such as the FSC Code of Conduct. Such development would be most effective if it were not a formal component of the regime because formalised code approval would decrease its responsiveness and flexibility, and diminish the accountability and professionalism of the industry.

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4. Which options for improving product design do you prefer and why? Do you agree with the pros and cons of the options? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

Option 1: A distribution banning power is a blunt instrument which may lead to unintended consequences. In principle we would support additional regulatory tools or requirements for certain specified products, but would argue that is contrary to a principles-based approach. Our preference is a positive regulatory approach that encourages providers to be accountable for responsible product design and for targeting products at appropriate customer demographics. We note that the FMA already has product stop powers.

Option 2: We recommend additional work on defining 'poor value' or poorly targeted products. We note that insurance products have different characteristics and conditions of acceptance than other financial products for which a product ban might be considered. The costs and consequences involved in revoking an insurance contract which may have been in place for several years may be significant. We note that this option is not a preferred MBIE option.

Option 3: Our members support the general intention of the requirement. As set out in our response to question 1, we suggest it is combined within an overarching duty to 'treat customers fairly.' We recommend focusing the requirement on the sufficiency of information provided to employees and intermediaries to explain (i) the purpose of the product or service and (ii) the customers for whom it is, and is not, intended.

5. If a design and distribution requirement like option 3 were chosen, are there particular products for which this is more necessary than others? If so, please explain what and why

Our members recommend that discretion remain with providers to decide which design and distribution situations, if any, warrant particular attention because their impact on customer outcomes will depend on the circumstances. Including accountability for design/distribution within a broader 'treat customers fairly' duty would provide that flexibility (see question 1).

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6. **Which options to improve product distribution do you prefer and why? Do you agree with the pros and cons of the options? Are there other impacts that are not identified – such as unintended consequences or impacts on particular business models? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?**

Option 1: Our members support there being accountability for the design of remuneration and incentive structures. We recommend that this form part of an overarching duty as discussed at question 1, rather than being a stand-alone requirement. Use of the term 'customer outcomes' should be structured to focus on the overall outcome, not merely short-term post-sale customer satisfaction.

QUICK WIN
There is work to be done in clarifying how best this can work, and the extent to which such accountability might / should reach intermediaries. However, we believe the principles involved in this can be identified in the short term.

Option 2: Some of our members support, in principle, a ban on remuneration and incentives (including soft commissions) based on sales targets, provided it would apply universally to all involved in comparable activities (eg intermediaries), not just to those entities covered by conduct regulation. In general, bans or caps risk unintended consequences so we recommend that the specifics be worked through in close consultation with industry.

Option 3: Our members recommend further work be done before considering option 3, including to ensure that in-house and intermediated sales would be treated comparably. We would welcome the opportunity to discuss with MBIE and FMA possible industry initiatives to assist in this area, for example to promote the use of 'balanced scorecard' approaches to variable remuneration for direct (in-house) sales. Such measures, underpinned by the duty to 'treat customers fairly', are likely to be far more effective in helping achieve the objectives of conduct regulation than outright prohibitions, bans and caps.

Option 4: Our members do not support option 4.

Option 5: Our members support option 5, preferably couched as part of an overarching 'treat customers fairly' duty. Two particular considerations arise:

- Intermediaries: The extent to which product providers would need to have oversight of its intermediaries' detailed activities is not clear from the proposed duty. Is accountability for customer outcomes shared between product provider, distributor and intermediary or does the provider (eg insurer) have ultimate responsibility? Should the answer to that question differ if the intermediary is already regulated (eg by these conduct laws or by FSLAA)? The FSC has drafted best practice on a shared responsibility model for industry oversight of intermediaries and would welcome the opportunity to discuss that with you.
- Lifecycle: The customer outcome – particularly for certain types of insurance – may crystallise many years after sale. It is unclear how accountability would apply across the lifecycle of a financial product (advice, sales, underwriting, in-force, renewal, claims, complaints etc).

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7. **To assist us in comparing the pros and cons of various options, please provide information about remuneration and commission structures currently in use. What are common structures, average amounts of remuneration/commissions, qualifying criteria etc.?**

Our members may submit individually on this question.

8. **What is your feedback on imposing a duty to ensure claims handling is fair, timely and transparent? Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of this option?**

Our members support this requirement, noting that it reflects the current industry approach to claims handling. It should be subject to more detailed discussion involving industry, Disputes Resolution Schemes and regulator to understand the role of the regulator in monitoring such a duty. We recommend consideration be given to making it part of a broader duty, as discussed at question 1, rather than a standalone duty. Alternatively, this option might be better addressed through the Insurance Contracts Law Review.

9. **If a duty to ensure claims handling is fair, timely and transparent were to be adopted, should an attempt be made to clarify what fair, timely and transparent mean? Why? Why not? What are the benefits and costs of doing so?**

This should be left to industry to address if clarification is required.

10. **What is your feedback on requiring the settlement of claims within a set time? Are there other impacts that are not identified? How do you think that exceptions should be designed? Should there be different time requirements for different types of insurance? Do you have any estimates of the size of the costs and benefits of this option?**

We support the general approach in the options paper to implement a regime that is principles based, with some prescriptive regulations for certainty. Accordingly, specifics about claim settlement times should not form part of the regime as each claim has a unique set of circumstances and facts. We note this option (option 2) is not part of MBIE's preferred package.

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11. Do you agree with the option to empower and resource the FMA to monitor and enforce compliance? Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

Our members support the FMA being the principal conduct regulator.

We recommend exploring how some activities (for example industry reporting, data analysis and setting best practice) are already handled by industry bodies, and how these and other activities could be further used by industry bodies in a self-regulatory role. That way, FMA resources could be focused on key activities, with industry being accountable for self-regulatory arrangements to handle other functions.

12. What is your feedback on the option to require banks and insurers to obtain a conduct licence? Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

Most of our members support entity licensing and recognise the regulatory advantages it offers, particularly if it is activity focused and applied to all engaged in that activity. Those who do not support entity licensing, are generally concerned about significant costs (which may ultimately be borne by customers) and the problems inherent with overlapping licensing regimes, particularly in the absence of any clear demonstration that this would improve customer outcomes.

Therefore, before implementation, there should be an efficiency review with industry input. It should extend to all overlapping licensing regimes with the aim of minimising duplicate effort for industry and Government, particularly where more than one regulator is involved. If an entity licence were to cover all activities an entity was engaged in, it may be made up of components of numerous activities (eg based by product and by advice) Any licensing regime should apply to all those engaged in the activity, as opposed to being determined by 'entity' status alone.

QUICK WIN

Subject to this measure having a reasonable transition period, and accompanied by an efficiency review of overlapping licensing regimes, we consider the introduction of universal conduct licensing for all financial institutions could be a 'quick win'.

13. What is your feedback on the option which discusses a broad range of regulatory tools? Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

Our members support the FMA having a full range of regulatory powers to properly execute their role. If those powers or resourcing would involve a greater industry contribution to FMA funding, that should be separately consulted on.

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14. Do you think that the maximum pecuniary penalties available for breaches of any conduct duties should be the same as the existing FMC Act penalties? Is there a case for making the penalties higher?

The appropriateness of pecuniary penalty levels in respect of conduct duties should be assessed once those duties have been finalised. In general, the current FMC Act is comparatively prescriptive and primarily focused on investment products. The conduct duties contemplated are high-level and principles based, and will apply in some cases to products that have far lower risk than investment products, so care should be taken to structure the penalty regime to ensure it is proportionate to the seriousness of the breach.

15. What is your feedback on the option of executive accountability? Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

Our members do not support an executive accountability regime being contemplated for now. We recommend implementation of the conduct duties first, and then reconsidering as part of a later phase whether executive accountability measures are required.

16. What is your feedback on the whistleblowing option? Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

This recommendation is not directly relevant to the objectives of the review, nor does it meet the test of being principles based.

We note that the State Services Commission is currently undertaking a review of the Protected Disclosure Act 2000 and consulted on various reform options in December 2018. The introduction of any new duties in this regard should be considered in conjunction with the outcomes of that review.

17. What is your feedback on the option of regular reporting on the industry? Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

Subject to cost / benefit considerations, our members are supportive, subject to:

- seeing the details of what is proposed
- the efforts required to supply such information
- consistency with data already provided to industry groups and regulators
- the utility that customers are likely to derive from it being done.

We recommend a trial period while usage is assessed. As noted at question 11, we recommend exploring how reporting activities could be taken on by industry bodies in a self-regulatory role.

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18. What is your feedback on the role of industry bodies? Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

The industry body landscape has changed significantly in the last two years, not least as a result of the focus on financial services conduct culture. Extensive effort is taking place across FSC members to promote accountability and to ensure that industry is 'doing the right thing'. Since the FSC Code of Conduct became effective on 1 January 2019, FSC members have worked together to create additional guidance on many of the key themes this review seeks to address. This best practice currently being reviewed and tested before launch. Transition periods are being considered as part of the review.

There are increasing opportunities for the regulator and industry bodies to work in partnership, in ways that will benefit all stakeholders including customers. While this does not have to involve formal recognition of self-regulation in conduct legislation, there should be sufficient flexibility in the regime for the FMA to foster some degree of self-regulatory accountability by the industry.

19. What is your feedback on the options regarding who the conduct regime should apply to? Do you agree with the pros and cons of the options? Are there other impacts that are not identified e.g. do the proposed overarching duties conflict with existing regulation that applies to other financial institutions? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of these options? Which options do you prefer and why?

Our members support the regime applying to all comparable activity. From a customer outcome perspective, it is the activity rather than the entity, that is relevant.

To the extent the activity (that is regulated for conduct purposes) depends on other parties (eg intermediaries), those other parties should be subject to equivalent requirements. The product provider entity should be able to rely on the fact that its intermediaries have parallel obligations, so that responsibility may be 'shared' across the chain from product provider to customer. This is not to lessen the responsibility of the provider, but it is necessary to clarify the nature of the responsibility. For example, it should not be the product provider's role to audit (or undertake client file reviews of) its distributors.

We acknowledge that the arrangements between the product provider and the intermediary are to be determined between the parties. However, we consider that regulation which enforces the need for intermediaries to demonstrate to providers that they are delivering good customer outcomes – and potentially to share information in this regard – is essential to support the objectives of the conduct regime.