

In Confidence

Office of the Minister of Finance

Office of the Minister of Commerce and Consumer Affairs

Chair, Cabinet

Government Response to the Bank Conduct and Culture Review

Proposal

1. We propose the Government takes a fresh look at how we regulate bank conduct in response to a potential regulatory gap noted by the Financial Markets Authority (FMA) and the Reserve Bank of New Zealand (RBNZ) in their review of bank conduct and culture (Review).

Background

2. Over the last 10 to 15 years New Zealand has systematically tightened regulation of the financial sector with a focus on high-risk products. The Credit Contracts and Consumer Finance Act 2003 (CCCFA) is enforced by the Commerce Commission and requires lenders to act responsibly at all times. The FMA was created in May 2011. The Financial Markets Conduct Act 2013 (FMCA) is enforced by the FMA and focuses regulatory attention on high-risk financial products. The Financial Services Legislation Amendment Bill is currently before the House and introduces a new regime for financial advice. All of this means that our financial markets regulatory system is generally in good shape.
3. The Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (ARC) was established on 14 December 2017. The ARC has uncovered numerous examples of misconduct, such as fees charged for no service, inappropriate financial advice and falsification of documents. An interim report was released on 28 September 2018 with a final report due 1 February 2019.
4. New Zealand agencies are taking the ARC's findings seriously. On 3 May 2018 the RBNZ Governor and FMA chief executive wrote to banks to reinforce banks' accountability for their own conduct and ask banks to show what they have done to ensure that there are no material conduct and culture issues within their business.
5. Following initial analysis of the banks' responses, the FMA and RBNZ initiated an extensive thematic review of banks' conduct and culture and sought to validate banks' responses. The Review involved 11 banks and 391 interviews with 572 bank staff in 13 towns and cities. A consumer survey was undertaken and meetings were held with: Consumer NZ; FinCap (provider of budgeting services); New Zealand Bankers' Association; Banking Ombudsman; First Union; and E tū (a workers union).
6. There has been widespread public interest in the Review. The FMA and RBNZ briefed the Finance and Expenditure select committee (FEC) on 30 May 2018 and

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informed it that work to date in New Zealand has shown plenty of areas for improvement but no evidence of widespread systemic issues.

7. The FMA and RBNZ are releasing a report (the Report) with the findings from the Review at 2:00pm today (Monday 5 November 2018). The FMA and the RBNZ have briefed us on the Report and their findings from the Review.
8. On 23 May 2018 the RBNZ Governor and FMA chief executive also wrote to life insurers asking them to outline what actions they have taken to identify and address conduct and culture risks (similar to the letter sent to banks on 3 May). Site visits and interviews are underway with life insurers in a similar manner to the bank Review.

Key findings from the bank conduct and culture review

Conduct and culture issues do not appear to be widespread

9. The review observed a small number of issues related to poor conduct by bank staff. Some of these related to inappropriate lending and sales, fees materially outweighing benefits to customers, manipulation of customer records to influence satisfaction outcomes, and manipulation of branch sales records.
10. The review did not find evidence to support these issues being widespread at this point. It is possible that more issues may come to light as banks continue their own work in response to issues identified by the ARC.
11. Any issues that warrant further investigation and potential enforcement action will be considered by the FMA, RBNZ or Commerce Commission, depending on who is responsible for the legislation relevant to the issue.

Banks need to improve their governance and management of conduct risks

12. The Review found significant variation in the maturity of banks' approaches to managing conduct risks. Some have been thinking about conduct issues for some time, while others have not. Most are only just beginning to embed a focus on long-term customer outcomes. The smaller banks generally demonstrated a customer-centric culture but their formal processes were less mature than the larger banks.
13. The FMA and RBNZ are concerned about banks' lack of proactivity in identifying and remediating conduct issues and risks in their business. The FMA and RBNZ identified weaknesses in the governance and management of conduct risks, and significant gaps in the measurement and reporting of customer outcomes. The FMA and RBNZ consider that if these weaknesses are left unchecked they have the potential to lead to widespread issues such as those seen in Australia.
14. The Report also notes that the risk of poor customer outcomes is increased by the incentives offered to staff, which are typically highly focused on sales performance.
15. The Report makes a number of recommendations common to all banks to improve oversight, controls and processes. This includes a recommendation that all banks review and remove sales target-based incentives throughout their operations. The FMA and RBNZ will also be providing specific feedback to each bank and asking them to develop an action plan to address the feedback by the end of March 2019.

There is a potential gap in the regulation of banking conduct

16. The Review has not identified any notable regulatory gaps for RBNZ. RBNZ can use its prudential powers if conduct risks threaten the soundness and efficiency of the financial system. However, the Review has highlighted a lack of specific regulatory requirements regarding conduct relating to customer outcomes – particularly when products are sold without financial advice. There is a lack of requirements for banks to have systems and controls that enable senior managers to identify and manage conduct risk, for capturing and reporting misconduct, for handling complaints and for undertaking remediation activity. This affects the FMA's ability to require changes in banks' governance and management frameworks for conduct risk.

Proposed Government response

17. The Minister of Commerce and Consumer Affairs already has a work programme underway to head off issues like those seen in Australia. This includes reforming New Zealand's financial advice regime, strengthening responsible lending laws and reviewing insurance contract law. The Reserve Bank Act is also under review.
18. However, given the Report's findings, we are concerned that there are still conduct and culture risks in New Zealand banks that could seriously undermine confidence in our financial sector, should they go unchecked. These are not risks we can ignore.
19. We propose that the Government takes a fresh look at the regulation of bank conduct. Addressing the regulatory gap as identified by the FMA and RBNZ will entail considerable policy work. This will be led by MBIE officials reporting to the Minister of Commerce and Consumer Affairs.
20. Without pre-empting the policy process, it is possible that a solution could require new legislative requirements. If this is the case, consideration will need to be given to what these requirements could be, how they fit with existing legislation, such as the Financial Markets Conduct Act, and appropriate enforcement mechanisms.
21. The FMA and RBNZ are still in the process of reviewing the conduct and culture of life insurers. We will report back when this life insurance work is complete (likely towards the end of this year or early next year). MBIE has also been considering the need for regulation of insurers' conduct. Should conduct rules be introduced, these would benefit from consistency across both the banking and insurance sectors.

Consultation

22. The FMA, the RBNZ, the Treasury and the Department of the Prime Minister and Cabinet (Policy Advisory Group) have been consulted on this paper.

Financial Implications

23. There are no direct financial implications at this stage. Initial policy work will be undertaken within departmental baselines.

Legislative Implications

24. There are no direct legislative implications from this paper.

Impact Analysis

25. This paper does not propose regulatory change at this point in time.

Human Rights

26. There are no inconsistencies between the proposals in this paper and the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993. There are no gender or disability perspective implications from the proposals in this paper.

Publicity

27. The FMA and RBNZ are releasing the report with the findings from the review at 2:00pm today (Monday 5 November 2018). The chief executive of the FMA and the Governor of the RBNZ will hold a joint press conference at 2:00pm.
28. The Minister of Finance and the Minister of Commerce and Consumer Affairs will issue a joint press release later this afternoon. The press release will welcome the report, note the need for the banks to lift their game and signal that MBIE will be taking a fresh look at New Zealand's regulation of bank conduct.
29. The FMA and RBNZ are scheduled to appear before FEC on Thursday 8 November.

Proactive Release

30. MBIE will publish a copy of this paper on its website.

Tabled by:

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