Financial Advice NEW ZEALAND

SUBMISSION ON OPTIONS PAPER – CONDUCT OF FINANCIAL INSTITUTIONS

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NOTE: Financial Advice New Zealand is the professional body for Lending, Risk, Financial Planning and Investment Advisers. Financial Advice New Zealand represents the interests of over 1,680 AFA and RFA members.

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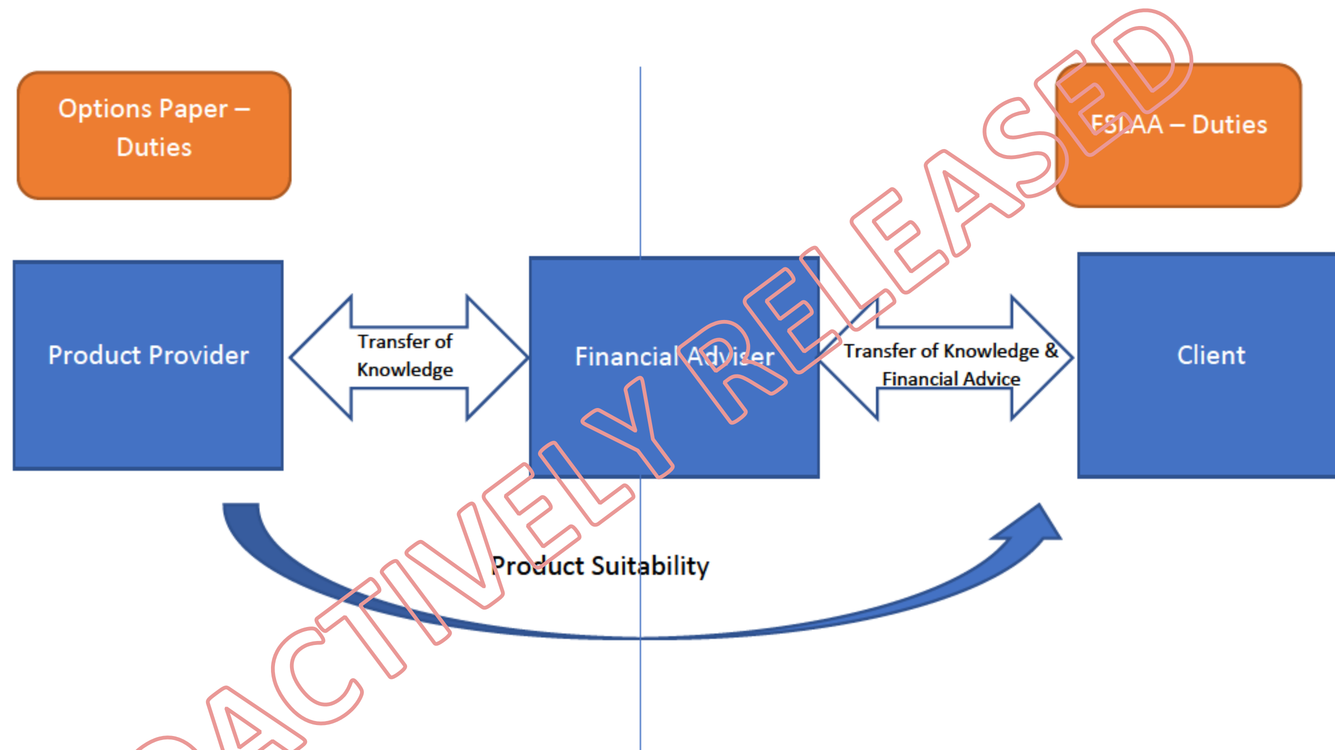
Introduction

We would like to set the scene of the current environment. We believe FSLAA provides the appropriate duties for financial advisers providing regulated financial advice. The product providers have a duty to ensure product suitability and the transfer of knowledge to the financial adviser. The financial adviser has a duty to transfer this product knowledge to the customer when providing personalised financial advice and provide feedback to product providers. There should be a bright line between the product providers duties and the adviser's duties.



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In this submission we use the term product provider to describe the Financial Institution which manufactures financial products for consumers.

The outcomes sought from this Options Paper is to ensure that conduct and culture in the financial sector is delivering good outcomes for all consumers. To achieve these outcomes five objectives were set:

1. Financial Institutions focus on ensuring good customer outcomes over the product lifecycle.
2. Retain access to financial products and services that promote good customer outcomes.
3. Alleviate the imbalance of power between customers and financial institutions.
4. Conflicts of interest are fairly and transparently managed.
5. Financial institutions take responsibility for managing conduct risks across the business.

This Options Paper identifies areas which can be strengthened; we caution on a number of fronts, which are expanded upon below which we believe will have unintended consequences of reducing access to a range of distribution types of regulated financial advice to consumers. i.e. access to Financial Advisers who are independently qualified to give financial advice.

We believe it is important to allow the implementation of FSLAA to occur so the financial services industry can adjust to the new licencing regime and the duties which are embedded in the legislation.

We further believe the pace of change is outstripping the capacity of the industry to get abreast of the change, and therefore strongly recommend a breathing period of twelve to eighteen months between the two policy initiatives of FSLAA and Options Paper - Conduct of Financial Institutions.

The proposals in this Options Paper includes duties similar to FSLAA which may blur responsibility and accountability between the product providers and the financial adviser. To instigate a new regime for financial institutions before the implementation of FSLAA could seriously add risk to the changing structure of the New Zealand advice sector.

If the product provider believes their liability includes duties in relation to the adviser role (due to being unable to distinguish between the duties of the two new Acts as they appear too similar) the unintended consequence will be;

- access to financial advice is reduced through the departure of the intermediary adviser channel.
- the provider may consider they need greater oversight of the intermediary adviser channel due to the duties thus reducing the intermediary adviser channel.

We appreciate commission can be considered a conflicted form of remuneration for the delivery of financial services; however, we have concerns that a significant change in the remuneration model may result in reduced access to financial advisers. We believe for many advice channels if a fees-based model had to be introduced, either partially or in full, this would make advice unaffordable to large segments of New Zealanders.

The remuneration model must be considered alongside maintaining a sustainable business model for advisers. In addition to this we have concerns some of the options may result in barriers for new entrants to the intermediary adviser channel, and participants in the market leaving due to there no longer being a viable business model for them to operate within.

In the Options Paper if you replace 'client' and 'customer' with 'consumer' the focus of the options paper becomes more clearly defined for providers and reduces the blurring of lines between the financial institutions and product provider sector, and that of the adviser sector and advice processes.

Responses

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?

It is fundamentally important there is no duplication of the duties which already apply to advisers and advice under FSLAA. The duties should be limited to duties of **product suitability, provision and servicing** and allow FSLAA to provide the framework for the duties for advice.

There is risk providers will consider they are liable for the advice related duties as the distinction between the two duties is not explicit enough.

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Option 1: A duty to consider and prioritise the customer's interest, to the extent reasonably practicable

The Options papers makes more sense if the words 'client' and 'customer' are replaced with 'consumer'. Financial Institutions, in their role as product-providers have a relationship to the consumer.

It is important product providers meet their contractual obligations under the product's terms and conditions. The product provider can prioritise the consumers interest by ensuring contractual terms, features and benefits, are expressed in a way that can be understood by the consumer, and the risks and consequences of the limitations of products are in plain language. In addition to this they have certain consumer obligations (not client obligations) e.g. to treat the consumer fairly and honestly in the discharge of their contractual dealings.

Similar to Duty 431K under FSLAA there could be an obligation imposed on financial institutions to give priority to the consumers' interest where there is a conflict with their own interest. It must be noted product providers should have no duty regarding the advice to purchase (or dispose) of the financial product.

Option 2: A duty to act with due care, skill and diligence

One of the times a duty to act with care, skill and diligence would be suitable for a financial institution is when staff are employed to ensure the contractual terms of the product are delivered. e.g. at claim time. or at the design stage to ensure product suitability for the consumer.

A duty to act with care, skill and diligence is a key duty under FSLAA. It would be extremely confusing for the consumer to understand who is liable for a breach of two identical duties across two separate pieces of legislation.

We cannot emphasize enough how similar duties will cause significant confusion and potential harm for the consumer and ultimately the product provider when using the intermediary channels.

The unintended consequence of this is the product provider may consider they have liability for all duties relating to due care, skill and diligence and become the supervisor of the advice process.

Option 3: A duty to pay due regard to the information needs of customers and to communicate in a way which is clear and timely

Customer or client communication obligations are covered under the duties of FSLAA and in the Code of Professional Conduct Standards.

Meeting consumer's communication needs is fundamentally important. The product provider needs to ensure there is simple, easy to read information which is easily accessible by consumers. In addition to this the adviser needs to be provided with consumer communication or updated product information, because the adviser already has this obligation to their client and, moreover know their individual communication needs

If the consumer was to receive personalised information from the product provider with every product development it would not add any value to the consumer, it would just simply overwhelm them with complex information and confuse them as to who is the relevant provider of advice. There needs to be a bright line between the communication of product providers and adviser's vs advisers and clients. There are key times in the relationship between the adviser and client where communication is important to ensure the client is well informed.

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Option 4: A requirement to have the systems and controls in place that support good conduct and address poor conduct

Agree

Option 5: A duty to manage conflicts of interest fairly and transparently

There could be an obligation imposed on financial institutions, to give priority to the consumers' interest where there is a conflict with their own interest, similar to Duty 431K under FSLAA on those who give advice.

Option 6: A duty to ensure complaints handling is fair, timely and transparent

We agree it is important the consumer can lodge a complaint with the financial institution regarding the product. There would need to be a bright line between product providers complaints and those related to financial advisers providing regulated financial advice. The advice process already has requirements for internal complaints processes and Approved Dispute Resolution Schemes to be in place.

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?

Managing conflict of interest should be a general conflict of interest. This allows for a much wider scope for conduct to be considered. An example could be around product suitability where the design of a replacement product reduces consumer benefits.

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

We believe a Code of Practice provides clarity around the interpretation of duties.

3.3 Options to improve product design

Option 1: Give the regulator the power to ban or stop the distribution of specific products

We believe there is existing legislation which provides these consumer protections.

Option 2: Ban certain products

We believe there is existing legislation which provides these consumer protections.

Option 3: Requirement for manufacturers to identify intended audience for products AND a requirement for distributors to have regard to the intended audience when placing the product

It is fundamentally important the end user is at the centre of product design and product suitability. The transfer of knowledge from product provider to financial adviser ensures the consumer will receive the correct advice in relation to the most suitable product for their needs. The adviser's role is to determine whether the product is suitable to be recommended for their individual clients and where necessary feedback to the product provider concerns relating to product suitability.

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

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that should be considered? Do you have any estimates of the size of the costs and benefits of the options?

We believe Option 3 would strengthen the product provider sector as the adviser needs to understand the intended audience and purpose of a product. This transfer of product knowledge should be consistent and clear. However, it is not the role of the product provider to review the advice given. This is covered under current legislation.

We believe Option 1 and 2 are already covered by existing consumer protections laws.

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.

This should apply to all products on the market as standard business practice.

3.4 Options to improve product distribution

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: A duty to design remuneration and incentives in a manner that is likely to promote good customer outcomes

We agree with designing remuneration and incentives that promote good consumer outcomes such as persistency, satisfaction, commitment to ongoing reviews and claims support. These incentives would reward good consumer outcomes. If the regulators were concerned about current behaviour this would incentivise good behaviour in the future.

The subject of vesting is also considered in this area where remuneration trail follows the current adviser providing the advice.

Currently, the ownership of trail commission is a commercial contract between the product provider and the financial adviser. If this was to change and trail commission were to follow the adviser providing the advice, then we strongly recommend this occurs on all new contracts and not to existing contracts. Consideration must be given to some existing business models that have been built on trail underpinning the valuation of the business.

Further consideration needs to be given to whether a customer states they want their current adviser to be remunerated from their existing contract, then the commission that is payable from that policy should be changed to the new adviser, from the existing adviser.

We believe where remuneration is being received a service level should be provided for this remuneration. This statement is not made in the context of contract law arguments of whether it is service commission or a form of payment for advice performed at the time of initial advice and sale.

Option 2: Ban target-based remuneration and incentives, including soft commissions (applies to both in-house and to intermediaries)

Commission is recognised as a form of remuneration for the provision of advice. If a change was to occur with sales-based targets (either volume or value) for remuneration, we believe a linear or flat line remuneration model would be appropriate.

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However, before any decisions are made regarding changes to commission remuneration models, we believe research needs to be done to ascertain what form and level of commission will ensure business sustainability for the adviser sector.

In addition to this there are adviser organisations such as dealer groups and aggregators which rely on volume commissions to provide support to advisers and are important to the ecosystem of advisers. These businesses will play an important role as FAP's in the new licencing regime. If this model was to change consideration would have to be given as to the timing of this change and the impact on this model to ensure business models could adapt and financial advice remains accessible.

It is accepted by the industry, volume based soft incentives will no longer be offered.

Option 3: Prohibit all in-house remuneration and incentive structures linked to sales measures

We are supportive of initiatives which focus on good customer outcomes.

Option 4: Impose parameters around the structure of commissions (i.e. commissions paid to intermediaries)

We do not believe you have to impose parameters around the structure of commissions.

In New Zealand when considering the commission structure, you also have to understand how financial advice businesses operate to ensure sustainable business models can be maintained to allow financial advice to be accessible to New Zealanders. There are commercial terms which are unique to the industry such as clawbacks which add complexity to the remuneration for an adviser.

We believe capping commissions on both upfront and trail is unnecessary due to their being no evidence of harm occurring for consumers. There is no strong evidence the current remuneration structure has caused significant additional costs or harm to the consumer.

We are aware of commission comparisons being made to other jurisdictions however, in New Zealand many advisers have direct business costs associated with delivering advice which in other jurisdictions these are covered by the product provider. Therefore, we consider these comparisons to be equivalent to comparing apples, oranges and pears.

However, if a cap was to be considered a cap on commissions 'specials' would be our first consideration as these offers seem to be designed for short-term tactical improvements in market share and could be seen to encourage advisers to consider inappropriate replacement business

The Options Paper refers to the Australian market. One of the significant differences between the markets in New Zealand and Australia is scale and advice diversity within their businesses. They typically manage higher average incomes, larger super balances, home loans and insurance spends. Many ordinary Australian consumers cannot access advice because they cannot or will not pay for advice.

In relation to churn - there appears to be a lack of evidence to support systemic issues of churn due to high up-front commissions. There is a difference between churn and replacement business and evidence needs to be provided to identify this issue is widespread. The FMA has done several investigations in this area where some churn has been identified and with the changes in FSLAA and Code, the incidences of churn will reduce (and with more passbacks, will occur even less going forward).

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The oversight responsibility should be for product providers to investigate 'red flags' and report systemic or noticeable levels of inappropriate activity by specific advisers, not to actively supervise all intermediaries.

It is fundamentally important consumers can access financial advice and the unintended consequences of reducing remuneration may lead to fewer financial advisers entering the industry and increase the numbers leaving. Remuneration models need to be considered in relation to business sustainability for the adviser sector and the clients advisers serve. This in turn directly impacts consumers and their ability to easily access intermediated face to face advice.

Option 5: A duty on manufacturers to take reasonable steps to ensure the sales of its products are likely to lead to good customer outcomes

We agree with this statement if the word 'customer' is replaced with 'consumer'.

We understand the intent of this Option but believe that there would be significant unintended consequences if not applied in a considered manner.

FSLAA duties ensure clients obtain certain outcomes and there is liability associated with breach of these duties. It is the product providers' responsibility to ensure product suitability at the design stage and the transfer of knowledge. This should be a bright line.

However, where the product provider is aware of unexplained product activity of a financial adviser the provider ought to have the responsibility to make enquiry of the adviser and if warranted escalate this to the regulator. Oversight by the provider should be limited to oversight of product activity and not advice processes itself as this is regulated by FSLAA. The responsibility needs to be crystal clear as to where the providers responsibility begins and ends and where the regulators responsibility begins and ends.

We would make the distinction between responsibility for oversight and liability. Liability on the product provider for the actions of the intermediary financial advisers may result in a reduction of the intermediary adviser channel as the provider will consider the intermediary adviser channel as an additional liability to distribute their product through.

Recommendations to buy financial products are in the Statement of Advice – these are the professional judgements and opinions of the adviser. These documents may contain multiple product recommendations sourced from a range of product providers which are suitable to meet the needs of the client. It is important that the product provider does not override an adviser's determination of product suitability and product recommendation to the client.

Further, a Financial Adviser needs to be able to freely assist their client if there is a need to interact with the product provider e.g. at the time of a claim, when a claim is disputed or declined, without any consequence from the product provider. Advocating on behalf of the client is a significant benefit of seeking intermediated financial advice.

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

3.5 Options relating specifically to insurance claims

Option 1: Duty to ensure claims handling is fair, timely and transparent

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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?

We support having a duty to ensure claims handling is fair, timely and transparent. Having guidelines to support these terms will add clarity to product providers and the sector as a whole and give consumers clarity as to what they have a right to expect.

Monitoring should be supported by reporting requirements for claims handling practices and settlement times. This oversight will increase public confidence and trust.

In addition to this, claims handling should involve the notification of relevant advisers when there is a claim so they can advocate on their clients behalf. Most people at claim time are at a vulnerable time and the additional assistance of an adviser is invaluable.

9 If this option 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?

Any clarification and guidelines to understand terminology can only strengthen the product provider being compliant and develop a better understanding for the consumer which further builds public confidence and trust in providers and advisers.

Option 2: Requirement to settle claims within a set time, with exceptions for certain circumstances

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?

The definition of timely is vital. Claims can be complex, and time frames can be affected by medical, financial and other factors beyond the provider's and the insured's control.

We know when a person makes an insurance claim they do so at a vulnerable period in their life. Therefore, we believe set timeframes on claims would bring certainty to the consumer - however this must be balanced with allowing the product provider adequate time to obtain relevant information to assess the claim. In principle, having certainty for claims to be assessed and responded to must build public confidence and trust in the insurance sector.

3.6 Options for tools to ensure compliance

Option 1: Empower and resource the FMA to monitor and enforce compliance

11 Do you agree with this 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?

In principle we agree the FMA is the logical body to monitor and enforce compliance. However, we see the role has to be greater than this to include engagement and education as it is pointless to implement regulation which is not understood. This should lead to greater public confidence and trust.

Option 2: Entity licensing

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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?

We believe if you implement Option 11 - Empower and resource the FMA to monitor and enforce compliance successfully then you don't need Option 12 of Entity licencing. We believe there needs to be evidence of systemic failure to implement a whole new licencing regime which has resourcing implications on the sector.

Option 3: Broad range of regulatory tools

13 What is your feedback on this 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?

If you were to implement Option 11 - Empower and resource the FMA to monitor and enforce compliance successfully then part of the equation must be to have a range of regulatory tools to take enforcement action. The combination of Option 11 and 13 should ensure good outcomes if applied appropriately and continue to build public confidence and trust.

Option 4: Strong penalties for non-compliance

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?

It is important there is consistency across other financial market regulation such as existing penalties under the FMC Act.

Option 5: Executive accountability

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?

No comment

Option 6: Require whistleblowing procedures to be in place

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?

We agree whistle blowing is an important part of the conduct and culture toolbox. Although they may be currently considered ineffective it is very important, they remain in place and are strengthened to protect those coming forward to report poor and unethical behaviour.

Option 7: Require regular reporting about the industry

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?

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We are supportive of having regular industry data. This could allow more informed decisions to be made in relation to product placements and increased consumer awareness. This would continue to build public confidence and trust in the purchase of a complex product.

Option 8: Greater role for industry bodies

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?

There are two distinct roles - one of the Regulator to enforce minimum standards and one for industry bodies to support standards and further develop and promote them. Industry bodies play a vital role in facilitating knowledge and ethical behaviour through education, sharing of ideas and debate. Further there is value to the entire financial advice sector when industry bodies promote the standards to which they are accountable to the public. If there was regulation that providers had to belong to an industry body then this would strengthen the reach of the industry body with a view of lifting standards across its members. Increased regulation increases the number of boxes which are ticked but it is the governance around understanding conduct and culture and the desire to continually improve standards which will ultimately create a vibrant, dynamic and ethical sector.

Part 4 – Who should the conduct regulation apply to?

Application of options to banks, insurers and other financial institutions

Option 1: Apply preferred package of options to retail banks and insurers 216. Under this option, the preferred package of options would apply to banks and insurers in respect of all products and services offered to retail customers. As noted below, the obligations would apply at the entity level.

Option 2: Apply preferred package of options to all those financial services providers that offer similar services to banks and insurers

Overlap with existing regulation

Option 1: Overlay preferred package of options onto existing regulation

Option 2: Carve out overlaps from existing regulation

Entity- vs product-level regulation

Option 1: Apply obligations at the entity, rather than product, level

19 What is your feedback on the options regarding who the conduct regime should apply to? In particular: 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?

Refer to the commentary in our submission.

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