MINISTRY OF BUSINESS,
INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

COVERSHEET

Minister	Hon Kris Faafoi	**Portfolio**	Commerce and Consumer Affairs
Title of Cabinet paper	Conduct of Financial Institutions: Introduction of a New Conduct Regime	**Date to be published**	9 December 2019

List of documents that have been proactively released		
Date	**Title**	**Author**
9 December 2019	Regulatory Impact Statement: Regulatory regime to govern the conduct of financial institutions	Ministry of Business, Innovation and Employment

Information redacted	**NO**

Coversheet: Regulatory regime to govern the conduct of financial institutions

Advising agencies	Ministry of Business, Innovation and Employment (MBIE)
Decision sought	Amend the Financial Markets Conduct (FMC) Act 2013 to introduce a regulatory regime governing the conduct of financial institutions
Proposing Ministers	Minister of Commerce and Consumer Affairs

Section A: Summary problem and proposed approach

Problem Definition **What problem or opportunity does this proposal seek to address? Why is Government intervention required?**
There are extensive weaknesses in the conduct and culture of institutions in New Zealand's financial sector, particularly in respect of governance and management of conduct risks and focus on outcomes for customers. Regulatory gaps also exist, which means that regulators are currently unable to properly oversee and respond to these issues. This has the potential to cause significant consumer harm in the long-run.

Proposed Approach **How will Government intervention work to bring about the desired change? How is this the best option?**
Government intervention will work to fill the regulatory gaps with regard to the core conduct of financial institutions and address the risk of consumer harm this creates. The recommended options will introduce a new regulatory regime governing the conduct of financial institutions, which will require licensing of banks, insurers and non-bank deposit takers (NBDTs) for general conduct and aspects of how sales incentives are offered. This will form the basis of a broader conduct regime that can be expanded over time if necessary.

Section B: Summary impacts: benefits and costs

Who are the main expected beneficiaries and what is the nature of the expected benefit?
New Zealand consumers of banking and insurance products are expected to be the main beneficiaries of these proposals. The ultimate intended outcome is improved conduct and culture in the financial sector which serves the needs and interests of consumers.

Where do the costs fall?
The most significant costs are likely to fall on: • Banks, insurers, NBDTs and their intermediaries selling products to retail customers. There will be a moderate-to-high increase in compliance costs for

regulated entities, depending on their existing levels of compliance, IT systems and organisational controls, as well as whether the entity is required to be licensed. It is likely that regulated entities will ultimately pass these costs through to their customers.

- The government and Financial Markets Authority. There will be a high increase in administration, monitoring and enforcement costs.

What are the likely risks and unintended impacts, how significant are they and how will they be minimised or mitigated?

- Reduced access to financial advice: Moderate to low impact. This risk will be minimised as the most intrusive regulatory options (i.e. banning or capping of commissions) are not recommended, which will reduce the risk of wholesale changes to business models and cash flows, and therefore minimise the risk of reduced access to financial advice.
- Reduced access to, or more expensive, financial products and services, for instance if costs are passed through to customers: May be moderately large in aggregate but low impact because costs are likely to be spread across a large number of customers and therefore immaterial at the individual customer level.
- Regulatory arbitrage: Low to moderate impact. We are reducing this risk by ensuring the entire chain of supply of banking and insurance products is covered by the options, as well as NBDTs to align with policy decisions to bring banks and NBDTs under one system of prudential supervision.
- Costs of compliance and lack of certainty exceed the benefits of regulation: Moderate impact. A compliance programme requirement increases compliance costs for entities but should enhance certainty and support monitoring and enforcement. To reduce the impact of this risk we also intend to start with a relatively small regulated population before considering the inclusion of other institutions who offer similar financial products and services.

Identify any significant incompatibility with the Government's 'Expectations for the design of regulatory systems'.

N/A

Section C: Evidence certainty and quality assurance

Agency rating of evidence certainty?

Overall we have a high level of confidence in the evidence base for the problem definition. The Financial Markets Authority (FMA) and Reserve Bank of New Zealand's (RBNZ) conduct and culture reviews of the banking and life insurance sectors have provided strong evidence of conduct risks and issues, as well as previous FMA thematic reports into bank incentives and soft commissions in the life and health insurance industry. There has also been extensive analysis of the life insurance industry in New Zealand, including the New Zealand Institute of Economic Research's 2015 report titled *Resetting life insurance*, and Melville Jessup Weaver's *Review of Retail Life Insurance Advice* which was commissioned by the Financial Services Council in 2015.

We also have evidence of individual consumer harm and common problems faced by consumers from submissions received on the Insurance Contract Law issues paper and

the 2018 MBIE/Colmar Brunton survey of insurance consumers. A range of sources have also provided evidence on the current sales incentive structures that exist in the industry, including submissions on the *Conduct of Financial Institutions Options Paper*, and discussions with stakeholders in the financial advice, banking and insurance sectors.

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
MBIE
Quality Assurance Assessment:
Meets the criteria necessary for Ministers to make informed decisions on the proposals in the Cabinet paper.
Reviewer Comments and Recommendations:
MBIE's regulatory impact assessment review panel (RIARP) confirms that its feedback is reflected in the Regulatory Impact Statement. The Regulatory Impact Statement has undergone moderate changes as a result of the RIARP process.

Impact Statement: Regulatory regime to govern the conduct of financial institutions

Section 1: General information

Purpose
The Ministry of Business, Innovation and Employment is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis
Scoping of the problem The rationale for our focus on the conduct and culture of financial institutions and conflicted sales incentives is that these are the biggest issues driving poor outcomes for consumers in the financial sector. This is a finding of both the Australian Royal Commission's report and the Financial Markets Authority (FMA) and Reserve Bank of New Zealand (RBNZ) joint reports into banking and life insurer conduct and culture. Because of the regulatory gaps and the significant risks of consumer harm, Ministers have directed MBIE to develop a high-level regulatory framework governing the conduct of financial institutions, which provides the foundation for a broad financial conduct regime. This will allow more prescriptive details to be developed over time, through regulations and further legislative changes. ***Evidence of the problems*** Much of the evidence of the problems is based on qualitative reports by the FMA/RBNZ into conduct and culture in the banking and life insurance sector, as well as submissions from individuals and organisations in the financial sector. These reports have their limitations in terms of scope and analysis, but provide valuable insights and findings on the existence of poor incentives and risks in these sectors. We have relatively little information about the prevalence of these issues in financial institutions other than banks and life insurers. However, we have some anecdotal and limited survey-based evidence, as well as international evidence[1], that similar problems also exist in other parts of the financial sector such as health insurance and general insurance. ***Range of options considered*** To address the issues set out in the next section, we have endeavoured to give priority to options which would not unduly disrupt the financial advice industry, especially given that it is already going through a period of significant regulatory change with a stronger regulatory

[1] See *Relevant overseas experience* in Section 3 below.

regime taking effect from June 2020. Therefore we have ruled out a total ban on commissions[2] to intermediaries, which would have had significant negative effects on the financial advice industry. Under the Financial Services Legislation Amendment Act (FSLAA) 2019, which introduces a new financial advice regime, financial advisers will be subject to a range of requirements, including the Financial Advice Code requirements to manage conflicts of interest, and disclosure of fees and costs associated with their advice. Further information disclosure in addition to FSLAA has therefore not been considered as an option as there are risks this will duplicate existing efforts, without directly reducing the conflicts of interest inherent in sales incentives.

We have also not considered further industry-led options or non-regulatory options, as these measures have already been attempted before with mixed results. While non-regulatory measures by the FMA and RBNZ have achieved some positive changes across banks and some life insurers, not all participants have met the regulators' expectations, particularly in the life insurance sector. In the life insurance sector, the first mover disadvantage in relation to the payment of commissions and other incentives makes it extremely unlikely for comprehensive and sustained industry changes without regulation.

Quality of data used for impact analysis

This RIS relies on a range of qualitative data to assess the impacts of the proposed options, including previous findings from the FMA/RBNZ reports and report-backs, and anecdotal evidence from public submissions. The sources used did not include much quantitative evidence of the problems identified or quantitative assessments of the costs and benefits of the options. We have made use of multiple evidence sources where possible, to increase the confidence we can place in the conclusions reached.

Consultation and testing

This analysis has been prepared under significant time constraints, which did not allow time for more extensive consultation with stakeholders on the development and refinement of options. The broader framework for the conduct regime has been developed in a short timeframe and we expect that there may need to be further refinements through consultation during the legislative process.

Responsible Manager:

Authorised by:

Sharon Corbett

Manager, Financial Markets Policy

Building, Resources and Markets

Ministry of Business, Innovation and Employment

November 2019

[2] Commissions are monetary payments offered by financial product providers to external intermediaries in connection with the sale of the provider's product, usually as a percentage of the customer's premium.

Section 2: Problem definition and objectives

2.1 What is the context within which action is proposed?

The context

Social context

Since the Global Financial Crisis in 2008, there has been a shift in focus from only looking at the prudential standing of financial institutions to also looking at their conduct and culture. Regulators around the world have been working to address broader issues like banks' market conduct, the suitability of financial products sold to customers, and the broader repercussions of an institutional culture that rewarded excessive risk-taking with little accountability on the downside. These issues in turn can harm consumers, damage a financial institution's reputation, and reduce trust in the financial system.

In mid-2018 MBIE consulted on an insurance contract law issues paper, which also included issues to do with conduct regulation of insurers (covering both life and non-life insurers). Since then, we have seen growing evidence that the gaps identified in insurer conduct regulation also apply more generally to all financial institutions.

Recent developments and findings in Australia stemming from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (ARC) have highlighted widespread failings in the treatment of customers across different parts of Australia's financial services industry. These misconduct issues are cause for concern, given that the development and maintenance of consumer and investor trust in the financial system is critical to its functioning. New Zealand's four largest banks, and a number of New Zealand's insurers, are Australian-owned, so the findings of the ARC have raised questions as to whether the same failings also exist here.

In 2018, the FMA and RBNZ conducted reviews of bank and life insurer conduct and culture. These reviews found, among other things, that sales incentive schemes are likely to drive staff to mis-sell, and that these risks were not being properly managed. Mis-selling in this context means being sold a financial product or service that the consumer does not meet the consumer's objectives or requirements, or that the consumer cannot afford.

Industry structure

This is a broad industry with a wide range of products and services, sub-sectors, business models and structures. While there are similarities across the industry, there are also marked differences. These similarities and differences need to be considered when considering how regulatory options impact different parts of the industry. Some examples include:

- General insurance contracts tend to be renewed each year, whereas life insurance contracts are 'for life'. Both general and life insurers sell their products through intermediaries who get paid a commission but the differences between the products have led to differences in how they are sold and the structure of the sales incentives offered (e.g. general insurance tends to be sold with a commission that remains the same over time whereas life insurance tends to be sold with a high 'upfront' commission followed by a smaller 'trail' commission paid over time).

- 'Group' structures (for instance Westpac Group includes both Westpac Bank and Westpac Life Insurance) mean that a bank teller might sell the group's Life insurance or KiwiSaver products and technically be considered as an intermediary.
- Aggregator groups such as adviser groups, where multiple advice firms are members of a group that interacts with a bank or insurer on their behalf and offers the advisers services such as increased bargaining power, training and client management systems. These groups tend to be paid an 'override' commission in addition to the commission paid to the advisers within them. These override commissions can be between 1-5 per cent of the annual premium for general insurance, and 10-30 per cent for life and health insurance products.

Nature of the market

Some of the product manufacturers we are considering are large and have considerable market power. However, intermediaries (particularly in the general insurance market) can also be large and exercise market power over the product manufacturers.

The unique importance and risks of financial products and services

Financial institutions, and the products and services they provide, are an essential part of a well-functioning society. They enable individuals to transact within the economy, save, borrow, and cover themselves against unexpected losses. In many cases these institutions, and their products and services, improve the wellbeing of the individuals and families in our community, as well as enabling businesses to invest and grow.

There are a number of factors that distinguish financial products from other types of products and services that consumers purchase on a regular basis. These factors create a unique set of risks for consumers, which are detailed in the problem section below.

The importance of financial products and services for wellbeing, coupled with the risk of harm and the consequences of that harm mean that financial products and services can have a bigger positive or negative impact on individuals and society than most other products and services.

The Counterfactual

The counterfactual assumes:

- No regulatory changes to improve financial institutions' conduct and culture.
- The changes under the FSLAA would be in effect (there would be a new regime for financial advice, including a requirement for financial advisers to give priority to the client's interest).

The FMA and RBNZ have written to banks and insurers asking them to modify their sales incentives and remuneration structures and practices. There has been a positive response to these requests from banks, with all banks committing to remove sales incentives for frontline staff and sales managers.

On the other hand, there have been mixed results from life insurers, particularly those that rely on intermediaries. While some life insurers are making positive changes (for example by amending their adviser agreements with a revised set of obligations to enable more effective oversight) we have also seen an example of a life insurer reassuring its advisers that they do not need to be concerned about changes to either commissions or adviser agreements in the next 12 months, unless required by law or regulation. Overall, in the life insurance sector there has been little movement in the levels of high upfront commissions, and sales incentives based on value/volume being retained.

Under the counterfactual there would be no legal obligation for banks and insurers to respond to the FMA and RBNZ requests. The current positive response of the industry is likely based on goodwill and the threat of regulation to follow. If regulation does not follow this would signal that it is acceptable for financial institutions to have a culture that places sales over and above the needs of individual consumers, and no accountability for poor outcomes such as mis-selling or the risks that come from churn.[3]

Under the counterfactual there would be no regulator with a direct legislative mandate for regulating the general conduct of institutions providing financial products and services to consumers. The FMA would have no ability to require financial institutions to change their conduct. Any financial institution that does not respond to the regulator's requests or reneges on its commitment would obtain a competitive advantage over other industry players. This would encourage other players to also ignore the regulator or renege on their commitments. Over time it could be expected that sales practices would return to how they are under the status quo.

Under the counterfactual the changes under FSLAA would be in effect, meaning that financial advisers would be required to give priority to their clients' interests. The FSLAA also includes a prohibition on providers offering their nominated representatives any kind of payment or incentive encouraging a breach of duties – including the duty to give priority to the clients' interests (section 431R(4)). However, there are risks that remain despite the implementation of FSLAA.

First, FSLAA does not provide any protections for consumers who purchase products or services without financial advice. This leaves a number of unregulated distribution channels – such as the sale of finance and insurance through car dealers and retailers.

Second, the FSLAA duty is focused on managing of the conflict of interest – it does not require the removal or reduction of this conflict. Financial incentives would remain for advisers (whether intermediaries or 'in-house') to prioritise their own interests.

[3] 'Churn' is the practice of moving customers from one life or health insurance policy to another in order to generate additional revenue from high upfront commissions. This practice creates a significant risk of harm to the customer if they lose cover for pre-existing conditions. This has the potential to be problematic, as 98 per cent of life insurance sales in New Zealand are replacing existing policies.

2.2 What regulatory system, or systems, are already in place?

Key features and objectives of the regulatory system

New Zealand has a 'twin peaks' model of financial regulation where prudential regulation and market conduct are administered by separate regulatory bodies.

The financial markets conduct regulatory system is a foundational system providing the legal framework for New Zealand's capital markets and financial services. That legal framework:

- provides for fair dealing in financial markets
- regulates offers of financial products and the governance of certain types of financial products
- regulates financial product markets
- regulates certain financial market services (including financial advisers and registration and dispute resolution requirements) and
- establishes and funds the FMA as the system enforcement agency.

The Financial Markets Conduct (FMC) Act 2013 is the main piece of legislation governing this financial markets conduct regulatory system. One of the primary objectives of the FMC Act is to ensure confident and informed participation of consumers in financial markets. Existing conduct regulation focuses on investment products, which were assumed to pose the highest risks, with an emphasis on providing sufficient information for informed decision-making. It largely does not extend to consumer financial products such as retail banking and insurance contracts. The FMC Act is enforced by the FMA.

The Financial Services Legislation Amendment Act 2019 (FSLAA) amends the FMC Act by providing for a new regulatory regime for governing the provision of financial advice. This is aimed at improving access to, and the quality of, financial advice.

The financial markets conduct regulatory system excludes prudential regulation of banks, non-bank deposit takers and insurers (which is led by the RBNZ). Prudential regulation is focused on institutional soundness, and promoting the maintenance of a sound and efficient financial system. The RBNZ is responsible for this under the RBNZ Act 1989. It registers and undertakes prudential supervision of banks under the RBNZ Act and insurers under the Insurance (Prudential Supervision) Act 2010.

The financial markets conduct regulatory system also excludes the consumer credit protections in the Credit Contracts and Consumer Finance Act 2003 (CCCFA), which is considered part of the commercial and consumer regulatory system. The CCCFA is enforced by the Commerce Commission. However, the CCCFA also seeks to protect the interests of consumers in connection with credit contracts, consumer leases, buy-back transactions of land and credit-related insurances, so there is likely to be some overlap in what is covered by the CCCFA and what will be included in the new conduct regime.

Fitness-for-purpose of the system

MBIE has primary responsibility for maintaining, monitoring, evaluating, and improving the financial markets conduct regulatory system. In doing so, MBIE is directly accountable to the Minister of Commerce and Consumer Affairs. A regulatory charter for the wider financial sector has been put in place under the auspices of the Council of Financial Regulators involving MBIE, FMA, RBNZ, and Treasury.

A regulatory system assessment is expected to take place every five years. The International Monetary Fund (IMF) also carries out an in-depth analysis of New Zealand's financial sector every ten years, and last carried out an assessment in April 2017. The IMF found that New Zealand's financial markets reforms had significantly improved the regulatory framework, and made recommendations to improve the regulation of some insurance intermediaries and the resourcing of the FMA. The broader piece of policy work to consider the conduct of financial institutions is taking some of the IMF recommendations forward.

2.3 What is the policy problem or opportunity?

Why does the counterfactual constitute a problem?

As outlined in the section on the counterfactual above, we consider that non-regulatory options are unlikely to lead to enduring positive changes in the sector. The characteristics of financial products and services mean that some underlying issues such as information asymmetry, conflicts of interest and an imbalance of power exist. Conduct and culture problems in the industry mean that institutions may not take these underlying characteristics into account or are able to take advantage of them.

The lack of an overall conduct regime for the financial sector means that there are regulatory gaps which exacerbate conduct and culture risks. Regulators are currently unable to properly oversee and respond to these risks or remediate issues where identified.

Without conduct regulation, the existing weaknesses in the governance and management of conduct risks and the lack of focus on consumer outcomes are likely to worsen over time, which could lead to more widespread consumer harm in the long-run.

There are also risks that remain despite the implementation of FSLAA. First, FSLAA does not provide any protections for consumers who purchase products or services without financial advice. This leaves a number of unregulated distribution channels – such as the sale of finance and insurance through car dealers and retailers. Second, the FSLAA duty is focused on managing of the conflict of interest – it does not require any reduction of this conflict. Product manufacturers are free to create incentives for financial advisers (whether intermediaries or "in-house") to prioritise their own interests.

General problems posed, and risks created, by financial products and services

Financial products and services create a unique set of risks for consumers. These include:

- When things go wrong with financial products or services it can be catastrophic at the individual level and cause significant harm at the broader societal and economic level.
- Many financial decisions are one-off with little ability for the individual to learn from

mistakes. For instance, a poor investment decision can result in an individual losing all of the wealth accumulated over their lifetime. A life insurance product that does not provide the cover expected can mean that an individual's family is unable to provide for themselves when that individual dies. Credit card debt can be crippling if it gets out of hand and mounts overtime. Often the cost is borne not just by the individual but by their family.

- Financial products can be difficult for consumers to understand. This information asymmetry means that consumers do not always understand exactly what they are purchasing and they cannot always tell when things are going wrong or whether a product is in their best interests. For example, it can take 20 years to know whether an insurance product was suitable, whereas a consumer is able to get clear feedback about the quality of a car or TV they purchase. The Insurance and Financial Services Ombudsman (IFSO), in their submission on the insurance contract law (ICL) issues paper, stated that: *"Cases about information and advice tend to involve mismatched expectations between the customer and the bank, either about whether insurance is in place or the scope of cover."* The Banking Ombudsman, when submitting on the same issues paper, noted: *"Some of our cases also illustrate a lack of consumer understanding about how insurance products work. For example, customers not being aware that premiums increase over time, funeral policies stop at 65, policies have expiry dates and are not perpetual, critical care may require a separate product to health insurance."*
- There is an inherent imbalance of power between financial institutions and consumers. This underlying problem was one of the Australian Royal Commission[4] (ARC)'s "four observations". The ARC observed that financial institutions acted the way they did "because they could" due to the marked imbalance in knowledge and power. The imbalance of power arises due to:
    - The information asymmetry mentioned above, which means a consumer does not always know when something has gone wrong or is not in his or her best interests. For instance, if a life or health insurance consumer is encouraged to change their policy or provider they may not sufficiently understand their contract to realise that they have lost cover for pre-existing conditions. The consumer may not realise this until it comes to claims time.
    - Consumers are offered standard form contracts with very little or no ability to negotiate.
    - Consumers have limited drive and resources to enforce a contract. For instance, Assure Legal's submission on the Insurance Contract Law issues paper noted that "*an older couple were pressured to replace a life insurance policy with a less suitable product, which subsequently ran afoul of a decline for a pre-existing condition… The claim would have been upheld and paid if the matter had gone to Court (it was outside of the IFSO jurisdiction) but the widow lacked the funds to pursue the case".*
    - It is difficult for consumers to organise themselves as a bloc to overcome lack of scale.
    - Disputes regarding financial matters create financial and emotional pressure

[4] The Australian Royal Commission report into *Misconduct in the Banking, Superannuation and Financial Services Industry*, which was released in February 2019.

on a consumer that can affect the consumer's physical environment (in the case of general insurance claims) and physical and mental health.

Problems at the product design stage

Products are not always designed with good customer outcomes in mind

There is variability in the processes financial institutions have in place for designing products. While some financial institutions design products with customer needs in mind, others have been primarily focused on how the product benefits the bank or the insurer, rather than customers.[5]

The FMA and RBNZ's review of life insurer conduct and culture found: *"There was limited evidence of products being designed and sold with good customer outcomes in mind, and very little in the way of policies for identifying and dealing with potentially vulnerable customers."* The report recommended that new products should be designed to provide good customer outcomes.

Poor-value products or products that are not fit-for-purpose

Poor-value products are products which often provide poor outcomes for customers due to limited benefits, misunderstanding of coverage and eligibility, or being sold to customers for whom the product is not suitable. For example, in their submission on the Insurance Contract Law Issues Paper, Consumer NZ identified credit card repayment insurance as a product that often provides consumers with very little benefit, as there are often significant limitations on the cover provided by this type of insurance it is unlikely to be a good choice for most consumers.

The problem with poor-value products is that while there may be a subset of customers for whom these products are suitable, for a high proportion of customers they provide little or no value.

For insurance, low rates of claims being made, or high rates of denied claims could indicate that products are poor-value or are being sold to customers they are not suited to, although this will depend on the particular product. The FMA and RBNZ's Life Insurance Conduct and Culture Review states that insurers have this information but do not fully utilise it when reviewing products, developing new products or determining who the products are suitable for.[6]

Problems in relation to sales incentives

Sales incentives of any kind increase conflicts between the interests of the salesperson and the customer (conflicted remuneration)

Conflicted remuneration increases the likelihood that a consumer is mis-sold something they do not need or something that does not end up meeting their needs. The points mentioned in the context section above about the nature of financial products and services mean that any conflicted remuneration in the financial sector has a significant impact on consumers.

[5] FMA/RBNZ Bank Conduct and Culture review and Life Insurance Conduct and Culture review.
[6] FMA/RBNZ Life Insurance Conduct and Culture review

Any individual who stands to benefit from the sale of a product or service is potentially conflicted when they make a sale. This is especially the case if the individual making the sale is expected to provide a service (such as providing information or financial advice) to a customer but gets paid for the sale rather than the provision of the service. At the point of sale they have their own interests to consider as well as the interests of the person to whom they are selling. If those interests do not align then there is a conflict of interest. This means that any form of variable remuneration or incentive linked to sales creates conflicts of interest. These conflicts of interest increase the risk that a consumer will be sold a product and service that they do not need or that does not meet their needs.

These conflicts of interest exist with all sales in many industries, not just financial services. However, as shown earlier, there are a number of factors that set financial products and services apart from other products and services and increase the potential for harm, including the fact that financial products are often complex and difficult for consumers to understand. Financial products are often long-term products, and the consequences of mis-selling are often not realised for a long time, or until a claim is made, which can be decades after the original sale. These factors mean that consumers often rely on the advice and information that they are provided and cannot always be expected to understand financial products and services well enough to make sound financial decisions. When something goes wrong it can be catastrophic for the individual.

In addition to this, some products, like credit and insurance, can also be readily "bundled" with other products that consumers might actually want (like a motor vehicle), which makes them easier to mis-sell. This makes the risk of mis-selling higher than for most other products.

The inherent conflicts of interest in sales incentives are exacerbated by how that incentive is structured

Common remuneration structures that increase the conflict of interest include:

- Sale targets and other volume/value-based commissions or remuneration (whether 'soft commissions'[7] or otherwise) – these exist across the financial sector and take many forms.
- High upfront commissions – these particularly exist in life and health insurance.

Any volume or value-based remuneration component increases the incentive to sell. These incentive structures are commonly used in New Zealand's financial sector, although they differ between products and financial institutions. The reward may be monetary in nature or a 'soft' commission, such as sponsorship, gifts, business support, educational and training programmes, shares and overseas trips. For instance, the FMA's 2018 thematic review of banks' incentive structures[8] found:

> *"Sales performance typically determines the majority of a salesperson's variable pay. Incentive schemes are structured to encourage high sales performance, commonly incorporating minimum sales thresholds and larger rewards for bigger sales. Manager incentives are typically based*

[7] Soft commissions are usually additional non-monetary benefits or incentives such as gifts, trips, sponsorships, hospitality given to advisers and salespeople to encourage them to sell the provider's product.

[8] http://www.fma.govt.nz/assets/Reports/181114-Bank-Incentive-Structures.pdf

on the sales performance of their salespeople, likely adding more pressure on staff to sell. This means that the risk of inappropriate sales practices occurring is high. It is therefore unsurprising that we were told by some salespeople of inappropriate sales practices taking place."

Remuneration tied to sales targets is particularly problematic because as the target is approached it creates an increasingly strong incentive to sell the product. Sales targets can result in staff pursuing sales in order to obtain a reward or avoid being performance managed by their bosses. The FMA's 2018 review of life insurer conduct and culture gave an example of one insurer where "*20 per cent of sales staff were on performance improvement plans and receiving additional coaching because they were not meeting sales targets. At this insurer, there were visible leader boards showing each person's number of sales, adding to the pressure on staff to sell.*"

Upfront commissions for the sale of life insurance commonly range from approximately 180 to 230 per cent of first-year annual insurance premiums, and average renewal commissions are usually between 7.5-10 per cent. This is less of an issue in general insurance, as policies are renewed on an annual basis. Commissions for the sale of general insurance are typically 10-30 per cent of the annual premium. High upfront commissions and lower renewal commissions can encourage "churn", which occurs when an intermediary switches customers between products or insurance providers in order to earn the upfront commission. While changing insurers or policies can be beneficial to the customer if they do not have any pre-existing conditions and end up with better value cover, in the life insurance sector, changing insurers or policies can be harmful if a customer loses cover for pre-existing conditions or ends up with cover that costs more over the long term than their previous cover. This was one of the findings of the life insurer culture and conduct report, as well as prior FMA reports. The life insurer conduct and culture report concluded:

> *"We saw evidence of sales incentive structures (internal and external) creating risks of sales being prioritised over customer outcomes and of policies being churned".*

Inappropriate policy replacement activity has been estimated to add 10-15 per cent to industry costs. In a life insurance industry with around $1 billion of annual life risk premium *"this equates to over $100 million every year in excess cost to customers and to the economy of New Zealand."*[9] Even where there is no direct harm to the customer, payments for replacement business that do not lead to a material benefit to the customer introduce unnecessary cost into the system, which gets passed on to policyholders.

A submission to the Finance and Expenditure select committee regarding the Credit Contracts Legislation Amendment Bill also raised a situation relating to interest rate differentials. The submission described a situation where a car dealer was an intermediary offering finance to potential car buyers. If the car dealer managed to sell the car on finance and managed to do so at an interest rate higher than the standard rate the dealer could keep half of the increase. E.g. if the standard interest rate was 20 per cent and the car dealer managed to sell a car and include finance at 25 per cent, then the car dealer would get 2.5 per cent of the interest paid. We cannot see any way in which this interest rate differential example leads to an outcome that is in the consumer's interests.

[9] Melville Jessup Weaver (2015). *Review of Retail Life Insurance Advice.* https://mjw.co.nz/wp-content/uploads/2015/11/MJW-Independent-Report-Final-November-2015_pwd.pdf

The life insurance industry has acknowledged these conflicts of interest. For instance, the FSC's submission on the insurance contract law issues paper stated: *"We acknowledge that sales incentives potentially create conflicts of interest. We also acknowledge some concerns about poor consumer outcomes arising from these conflicts".*

The life insurer conduct and culture report noted the possibility that the general conduct and culture issues identified in the life insurance sector also exist across other insurance sectors. While the FMA and RBNZ have not undertaken an in-depth conduct and culture study of general insurers, many of the incentive and remuneration structures are similar to those existing in life insurance and banking (with the exception of high up front commissions). This implies that the risks associated with conflicted remuneration also exist in the health and general insurance industries.

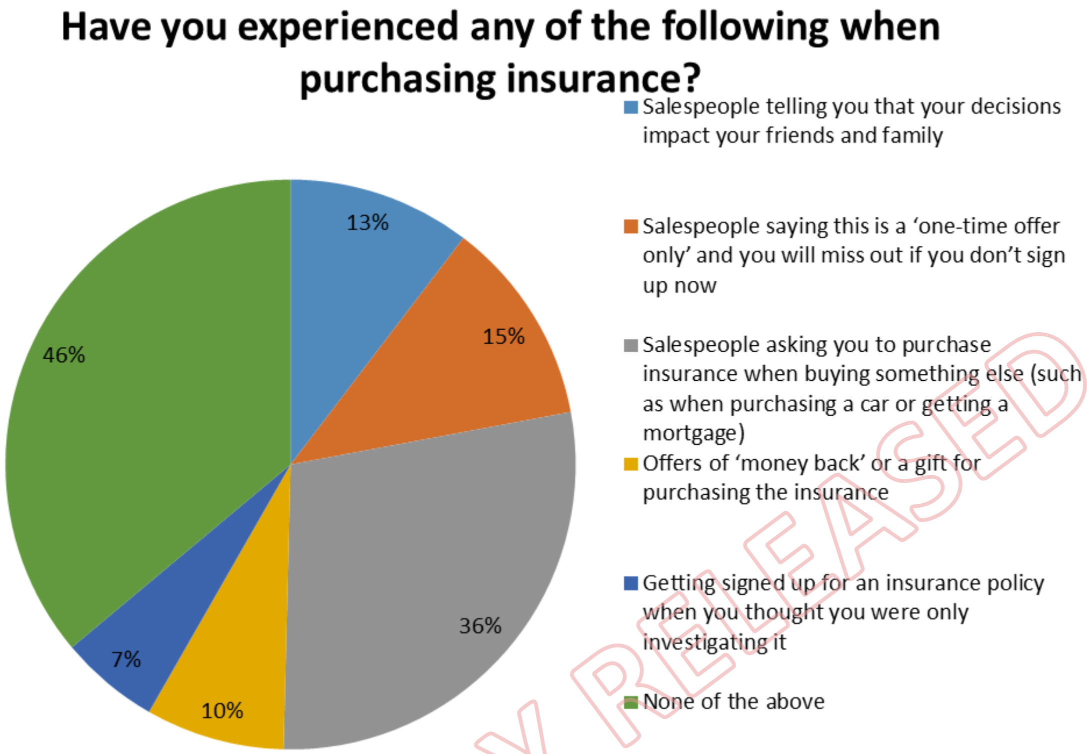
The bank conduct and culture report concluded that the sales performance measures for front line staff and their managers meant *"that the risk of inappropriate sales practices occurring is high. It is therefore unsurprising that we were told by some salespeople of inappropriate sales practices taking place."*

The life insurer conduct and culture report concluded that incentives offered to sales staff and high upfront commissions and 'soft' commissions offered to intermediaries were typically highly focused on driving sales, which increased the risk of poor conduct.

Overall, the FMA/RBNZ reports found that often sales are seen as more important than good customer outcomes.

The ARC into Misconduct in the Banking, Superannuation and Financial Service Industry has found that Australia's financial sector has been focused on short term profit and sales at the expense of basic standards of honesty.

Evidence from the 2018 Colmar Brunton/MBIE survey of insurance consumers suggests that over half of insurance purchasers may have experienced some form of attempted pressure-sale (see chart below). While many of the sales techniques mentioned below can be legitimate, they can also be used to unduly increase the pressure on a consumer to make a purchase. When insurance is strongly pushed the risk increases of consumers buying a product that they do not need or that does not meet their needs.



Source: Colmar Brunton survey of insurance consumers, commissioned by MBIE in 2018

Consumer NZ's submission on the ICL issues paper noted that their "latest banking satisfaction survey shows 27 per cent of bank customers reported getting unsolicited offers from their bank in the past year. Life insurance was among the most commonly offered products. Only 21 per cent of consumers offered the product considered it was suitable for them."

Submissions on the ICL issues paper also raised numerous examples of, and concerns about, mis-sold insurance. Some of these include:

- Concerns that sales of add-on insurance through car dealers often provide consumers with very little benefit but may be presented as a requirement when vehicles are bought on credit.
- Income protection cover being sold to people who are not employed.
- A tetraplegic individual who had life insurance but a carve-out for anything related to tetraplegia, making the cover essentially meaningless.
- A 25-year-old consumer with no dependents was sold a life insurance policy by his bank when he signed up for KiwiSaver. He only purchased the product because he was led to believe it was required as part of joining KiwiSaver.

Sales incentives are one of the reasons why financial products get pushed.

> *"The mis-selling of personal protection insurance in the UK and the evidence presented to the Royal Commission in Australia shows that financial services is susceptible to pressure sales. In part this is due to risks inherent in the intermediated*

distribution of insurance." (Rebecca Sellers' submission on the ICL issues paper.)

"We do consider there is a serious risk that sales incentives contribute to poor outcomes for consumers…" (Financial Services Complaints Ltd (FSCL)'s submission on the ICL issues paper)

In May 2018 the FMA also undertook a thematic review looking at soft commissions in the life and health insurance industry.[10] The FMA concluded that soft commissions were effective sales incentives for financial advisers. They found that:

- A higher value of soft commissions is related to higher sales income for insurers.
- Increased spending by insurers on soft commissions appears to correspond with increased sales, but only by a small amount.
- The qualification date for trips appears to correspond with a peak in sales.
- When one insurer removed overseas trips their saes dropped by about a third in the year after the trips were removed.
- 42 per cent of soft commissions required the adviser to sell a particular number or value of the insurer's product.

The FMA concluded that this suggests that "*soft commissions definitely have an impact on adviser behaviour, and that in some instances advisers are acting in their own interests, rather than their customer's interests.*"

If the sales incentives that are in place actually work then we would expect financial institutions and their front line staff to place a strong focus on sales. We see this in New Zealand, including some evidence of pressure sales.

Financial institutions are not adequately managing the risks associated with conflicted remuneration

Despite the high risk of inappropriate sales practices occurring, financial institutions (who create the conflicted remuneration structures) are not adequately monitoring and controlling this risk. The FMA and RBNZ conduct and culture reports found a lack of investment in systems and processes for measuring and reporting on customer outcomes and a general lack of effective controls and governance. This means that the risks of mis-selling is not being properly identified and mitigated. Some firms failed to identify how their incentive schemes may encourage their staff to mis-sell. This suggests they have not sufficiently considered the risks, or have ignored these risks. For example, for life insurance products sold without advice, particularly via telephone sales, the FMA and RBNZ report found there are limited or no processes to consider customer needs and suitability.

In 2018 the FMA conducted a thematic review of qualifying financial entity (QFE) insurance providers' replacement business practices. They found that *"less than half of the entities advise customers that replacing their life insurance could lead to worse cover or the potential loss of benefits. This casts considerable doubt on whether consumers have adequate*

[10] FMA, May 2018. Accessed at: http://www.fma.govt.nz/assets/Reports/Conflicted-remuneration-in-the-life-and-health-insurance-industry.pdf

information to allow them to reach an informed decision, especially taking into account the complexity of insurance replacement. Seven of the 11 entities specifically advise their staff that they expect them to prioritise the interests of their customers, or words to that effect. However, their sales practices for replacement business are not always consistent with this."

The FMA's 2018 thematic review of bank incentive structures found that:
"Controls appear to be ineffective at mitigating conduct risks… controls are often designed and conducted in a way that makes it unlikely they will be effective at identifying inappropriate sales. This means poor customer outcomes are likely to go undetected… Boards and senior management often seek and receive little information on the risks of inappropriate sales. While boards and senior management receive information on the operation of incentive schemes themselves, some receive little information on the risk of inappropriate sales and how that risk is being managed."

Other problems at the product distribution stage

Lack of oversight of intermediaries

For financial institutions distributing products through intermediaries, communication with customers is often inconsistent and, in some cases, largely left to intermediaries. The FMA and RBNZ reports particularly identified issues in the life insurance sector. The FMA and RBNZ found that some life insurers considered direct communication with customers to be inappropriate, as the customer 'belongs' to the intermediary and that the conduct of the intermediary was not their responsibility. We have also heard that some insurers are contractually prohibited by advisers from communicating with the end customer.

The FMA and RBNZ report into bank conduct also found that, while a number of banks highlighted conduct risks associated with their limited oversight of the customer interactions that occur through intermediaries, there was little evidence of banks having enhanced controls and oversight of their higher-risk products and distribution channels.

This has led to some financial institutions stating that they do not have any responsibility for customer outcomes where the products are sold by intermediaries, and making little effort to maintain visibility of customer outcomes. This is problematic as it significantly increases the risk of poor conduct going undetected and customers being sold unsuitable products. This issue may be exacerbated where intermediaries carry out functions that would usually be viewed as core functions of a financial institution (such as underwriting, settling claims and designing policies).

Other problems identified

Systems are not always updated to implement new products/promotions

In their reviews of banks and life insurers the FMA and RBNZ found examples of underinvestment in systems and training as well as reliance on manual processes to compensate for system weaknesses.

This overreliance on manual processes heightens the risk of errors or omissions that ultimately impact customer outcomes – such as when details are incorrectly recorded or fees are incorrectly charged. Inadequate system support and integration may also mean that where errors or omissions occur they are not identified and remedied within a reasonable timeframe.

Poor systems can also lead to some customers (e.g. new customers) getting better support than others (e.g. old customers). The FMA and RBNZ life insurer report noted that legacy customers (or indeed customers who use products that lack system support) are sometimes given less attention than newer customers or treated in a way that risks poorer outcomes for them.

Communication breakdowns when claims take long periods of time or are disputed

Submissions to the Insurance Contract Law issues paper highlighted that inadequate attention is often given to communication with customers at important stages of the contractual relationship other than contract formation. Specifically, communication breakdowns were reported where claims on an insurance policy are made and take a long time to settle or are disputed by the parties.

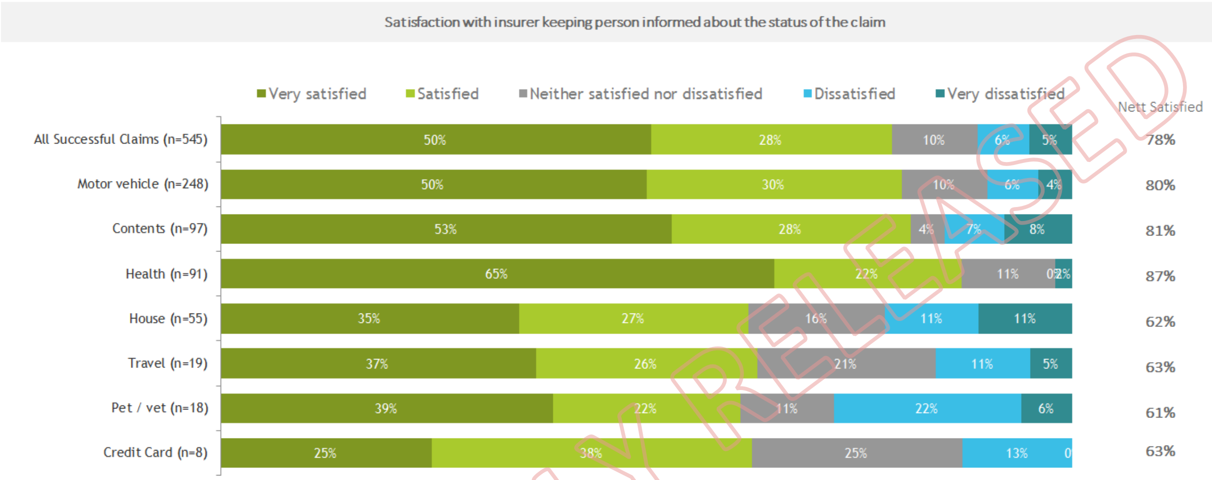
A lack of communication or a breakdown in communication with customers presents a high risk of poor customer outcomes, especially where there is a large focus placed on initial sales and the sometimes distressing nature of events that necessitate making a claim on an insurance policy. As the review of life insurers pointed out, ongoing communication with customers appeared limited and compliance-orientated rather than driven by a desire to be proactive.

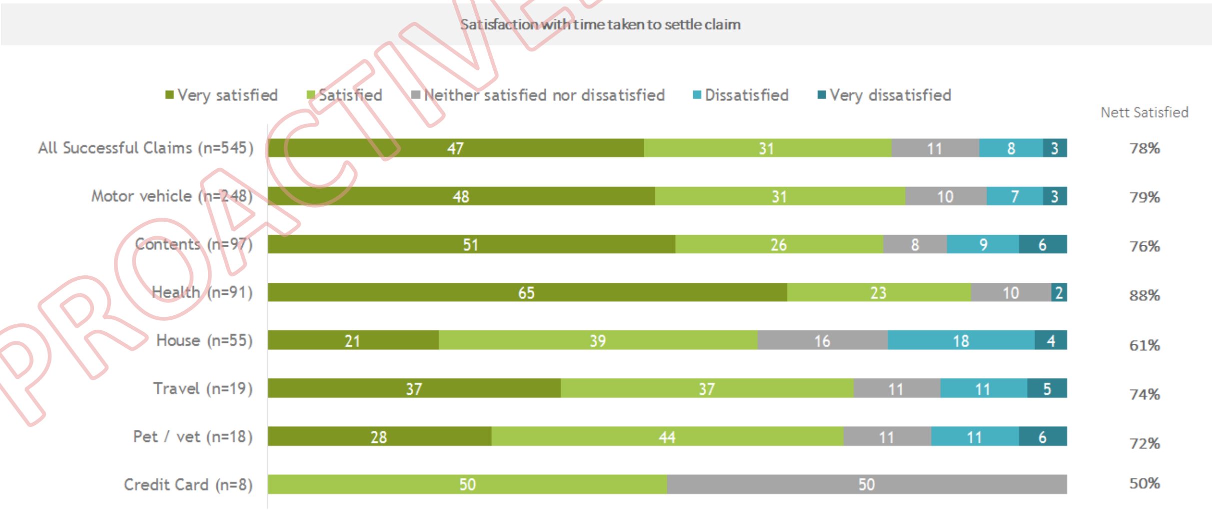
Insurance claims are not always handled in a fair, timely and transparent manner

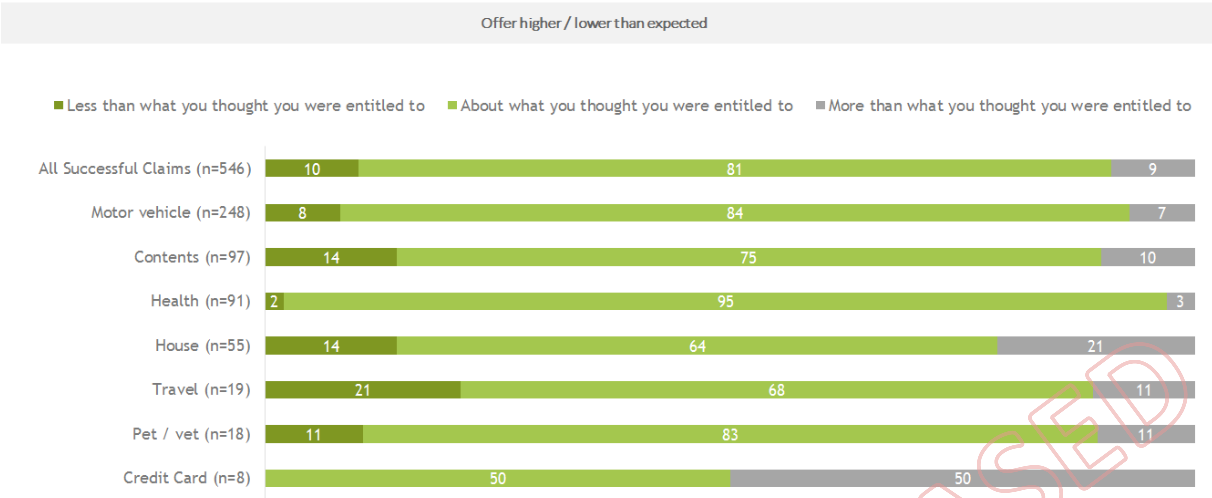
Disputes regarding financial matters create financial and emotional pressure on consumers which can significantly affect their physical environment (in the case of general insurance claims) and physical and mental health (relevant to most types of insurance). Consumers may consider the process is unfair or lacking in transparency when claims handling is taking longer than expected, or when lower than expected settlement amounts are being offered by the insurer. If the customer disagrees with an insurer's assessment, it can be difficult for the customer to challenge the decision and enforce their contractual rights. For example, disputes with a value of greater than $200,000 cannot be taken to the IFSO and must be taken to the courts.

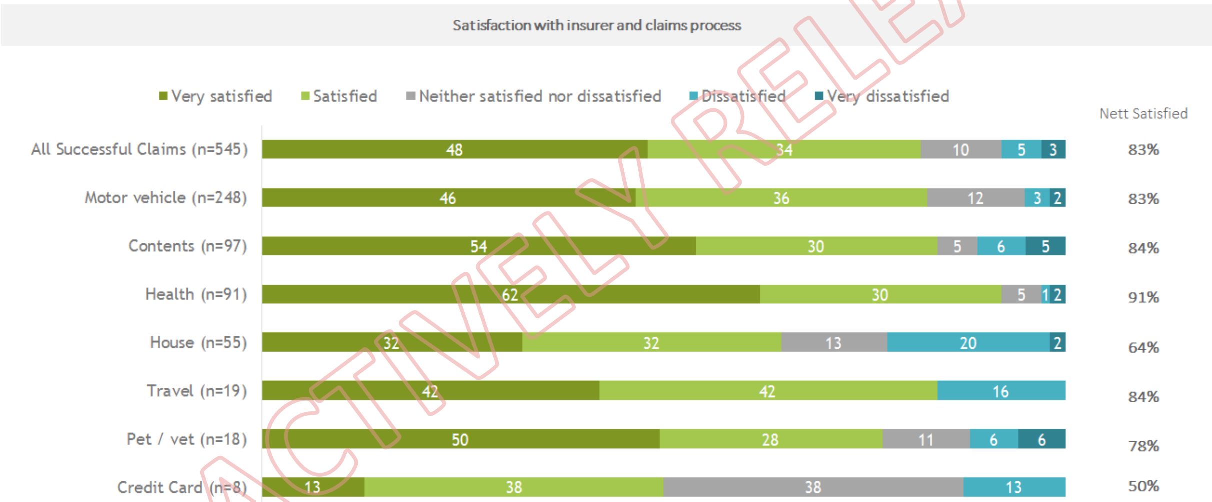
Submissions on the Insurance Contract Law review indicated that many consumers experienced delayed and drawn-out disputes over claims, and felt pressured to settle for an amount that was lower than they expected to be owed. For instance, one independent claims management company provided MBIE with data from 181 claims that it helped to manage following the Christchurch earthquakes. Across these claims the average value of the claim (as assessed by the insurer) when the customer approached the claims management company was $294,503. Following the intervention of the claims management company the average value of the final settlement was $727,056. However, we note that the Canterbury situation was one of the world's largest and most complex insurance claim events, may not be representative of usual claims experiences, and involved a wide range of factors that complicated the settlement of claims in this context.

Below are a number of charts drawn from nationally representative research conducted in 2018 for MBIE by Colmar Brunton. The data in the charts represents successful claims in the last two years. The charts show that while there are many claims that were settled satisfactorily, there is also a significant proportion where claimants felt that they were not kept well informed, claims took too long to settle, settlements were less than the claimant thought they were entitled to, and the claimant was dissatisfied with the insurer and claims process.









Summary of problems

Together, the problems related to mis-selling, product design, poor remediation of customer issues and weaknesses in the management and governance of conduct risk all indicate broader failings in the conduct and culture of financial institutions.

While there are inherent risks in financial products and services due to the nature of the market, there is evidence of weaknesses or failings in conduct and culture at every point of the product lifecycle. There is particularly strong evidence of conflicted sales incentives, which is a key underlying cause of poor conduct and culture. We therefore think there is a strong need for a broad regulatory regime to govern the conduct of financial institutions, and more specific obligations to address conflicted sales incentives given the prominent evidence of harm in this area.

Robustness of evidence

These problems have been raised through the FMA/RBNZ reports, as well as submissions on the ICL issues paper and the options paper on the conduct of financial institutions. A range of information was requested by the FMA/RNBZ and the responses from 11 banks and 16 life insurers were assessed by the FMA/RBNZ to reach the conclusions in their reports. The FMA/RBNZ reviews also included further monitoring activity by the regulators to validate the information provided, interviews with staff and feedback from external stakeholder groups (including Consumer NZ, the Financial Services Council, FSCL and IFSO).

2.4 Are there any constraints on the scope for decision making?

The timing for decisions has been a constraint on the scope for decision making. As noted in Section 1, the Minister of Commerce and Consumer Affairs has directed MBIE to prepare legislation to be introduced by the end of 2019.

We think a broad financial conduct regime is required. This RIS sets out a high-level framework for a broad conduct regime but the details will need to be fleshed out over time, through regulations and potentially further legislative changes, once there has been opportunity for further policy thinking.

There are some interdependencies with the new financial advice regime under the FMC Act, which aims to address some conflicts of interest in the financial advice industry.

The policy framework also makes use of the existing regulatory tools in the Financial Markets Conduct Act 2013 rather than revisiting all of these tools and powers.

2.5 What do stakeholders think?

Who are the stakeholders? What is the nature of their interest?

The main stakeholders are the providers of financial products and services, the distributors of these products and services (i.e. financial advisers and other intermediaries), the regulators, and consumers of these products and services.

Summary of key themes from options paper submissions regarding the duty to consider and prioritise the customer's interest, to the extent reasonably practicable

Submitters were relatively evenly split on whether or not they supported a duty to consider and prioritise the customer's interests to the extent reasonably practicable. Those that submitted against the introduction of this duty mostly suggested that this was too vague and ambiguous. Some of the submissions that supported the duty also stated that more guidance would be needed in order for the duty to be workable. Many of the submissions mentioned a preference for a standard of fairness rather than prioritising customer's interests, stating that this would maximise consistency with other laws and codes.

Summary of key themes from submissions regarding the duty on manufacturers to take reasonable steps to ensure sales are likely to lead to good customer outcomes

Submitters were generally supportive of the duty on manufacturers to take reasonable steps to ensure the sales of its products are likely to lead to good customer outcomes but raised some concerns such as the need to recognise the separate roles and responsibilities of intermediaries and manufacturers, and the limited control manufacturers have over intermediaries to ensure this duty is practical and workable. A common concern was that this duty could impose obligations on manufacturers that they may be unable to fulfil, because it may require action or an outcome that is outside their control. Many submitters, while supportive of the duty, requested that more clarity be provided about the extent to which manufacturers should have oversight of distributor conduct. There was general support for the 'reasonableness' standard included in the duty, though some submitters stated this would need clarification/guidance as to what 'reasonable steps' are.

Summary of key themes from submissions regarding incentives

Submitters were generally in agreement that rewards based on sales alone can create tensions with good outcomes, particularly for frontline staff. Submitters were broadly supportive of initiatives which focus on consumers and their interests. There was general acknowledgement that soft commissions generally no longer have a place in the industry as a justified means of incentivising.

There were some divergent/alternative views, including comments that there was a lack of evidence of harm from incentives and that the phrase 'good customer outcomes' is not fit for purpose. Some submitters thought that the problems identified have been sufficiently addressed by existing law and/or new FSLAA regime. Concern was expressed that significant change in remuneration models may reduce access to financial advice.

What consultation has already taken place and with whom?

A public consultation document titled *Conduct of Financial Institutions Options Paper* was released in April 2019 seeking public feedback and views on wider conduct and culture problems in the financial services sector and proposed solutions. Around 85 submissions were received from a range of stakeholders including large organisations, small-to-medium financial advice providers, industry bodies, dispute services and the general public.

In addition, an *Insurance Contract Law Review Options Paper* also released in April 2019 sought public feedback on more technical insurance contract law problems and proposed solutions which are of relevance to this work. Around 300-400 submissions were received from a range of stakeholders and where relevant have been considered. Prior to this, an *Insurance Contract Law Issues Paper* was released in mid-2018, which, in addition to technical insurance issues, sought feedback on issues with the conduct of insurers. Around 110 submissions were received on that Issues Paper and have been considered in the current review of the conduct of financial institutions.

2.6 Objectives

Our overall goal is to ensure that conduct and culture in the financial sector is promoting good outcomes for all customers.

In the context of this review, ‘good outcomes for all customers’ means that their interests and needs are served by financial institutions. These interests and needs include treating customers fairly, ensuring products are suitable and understood, identifying and remediating issues in a timely manner, and mitigating the risks of mis-selling. This is aligned with one of the main purposes of the FMC Act, which is to ensure confident and informed participation of consumers in financial markets.

To achieve this goal, we have set a number of policy objectives for this review:

Financial institutions are treating customers fairly

Customers should expect their financial products and services to meet their needs from institutions they trust. Financial institutions should be able to show consistently that fair treatment of customers is at the heart of their business model.

The imbalance of power between customers and financial institutions is alleviated

There is an inherent imbalance of knowledge and power between customers and financial institutions. It is important that institutions recognise and mitigate this power imbalance and ensure customers can understand the products and services they are offered.

Financial institutions have appropriate systems and controls to govern and manage conduct

Financial institutions need to have appropriate systems and controls to support good conduct and address poor conduct. This objective is about identifying and remedying issues and risks of poor outcomes in a timely manner, and ensuring products operate as intended.

Financial institutions take responsibility for managing conduct risks

Financial institutions ultimately need to be accountable for ensuring that their governance structures, control mechanisms and culture support good organisational conduct. Where intermediaries are used, there needs to be a shared responsibility for ensuring good customer outcomes.

For ease of reference, the criteria that we use in the impact analysis section combines the four objectives above into one overarching criterion: Effectiveness in addressing broader conduct and culture issues.

The criteria used in the impact analysis section also include the two more specific objectives below, which are focused on addressing issues with conflicted remuneration.

Conflicts of interest throughout the chain of supply of financial products and services are reduced

Providers and distributors of financial products and services often face inherent conflicts of interest, because they may have incentives (due to existing remuneration structures) to sell products and services which are not necessarily aligned with the consumer's interests and needs. Where possible, incentives should be realigned to reduce conflicts of interest, rather than taking measures that merely manage conflicts of interest.

Consumers continue to have access to high quality financial advice, and suitable financial products and services

All consumers should be able to access the right kind of advice and suitable financial products and services to meet their needs and interests. Some remuneration structures are fundamental to the sustainability of the financial advice industry in New Zealand, and we consider it is important to retain consumer access to high quality financial advice.

Section 3: Options identification

3.1 What options are available to address the problem?

Summary of options

To address the problem above, we are considering the following options below.

- Option 1: A high-level ‘fair treatment’ conduct standard (**preferred**)
- Option 1A: Licensing regime for banks and insurers (**preferred**)
- Option 1B: Obligation regarding how banks, insurers and NBDTs design incentives (**preferred**)
- Option 2: A prohibition on internal and external remuneration and incentives based on sales value or volume, including soft commissions (**preferred**)
- Option 3: Prohibit internal remuneration and incentive structures linked to sales measures
- Option 4: Impose parameters around the structure of commissions
- Option 4A: Impose parameters around the structure of commissions for the sales of life and health insurance.

The table below sets out which problems are addressed by each of the options above. As noted earlier, there are broad conduct and culture issues as well as more specific issues with conflicted sales incentives. This is why we are considering a high-level ‘fair treatment’ standard to govern conduct and culture, supported by specific options to address conflicted sales incentives. The proposed high-level conduct standard implemented through a licensing regime will enable more specific regulatory obligations to be brought in over time, to address the wider problems.

		Options identified						
		1	1A	1B	2	3	4	4A
Areas where problems have been identified	Product design	✓	✓	✗	✗	✗	✗	✗
	Sales incentives	✓	✓	✓	✓	✓	✓	✓
	Product distribution	✓	✓	✓	✗	✗	✗	✗
	Systems and controls	✓	✓	✓	✗	✗	✗	✗
	Communications	✓	✓	✗	✗	✗	✗	✗
	Claims handling	✓	✓	✗	✗	✗	✗	✗

Scope of these options

Which entities would these options apply to?

Banks, insurers and Non-Bank Deposit Takers (NBDTs) would be captured by options 1, 1A and 1B. These institutions would be responsible for ensuring that those of their intermediaries who are not financial advice providers complied with the obligations.

Option 2 would apply to Banks, insurers and NBDTs, as well as all of their intermediaries.

Option 3, while not preferred, would apply to sales incentives provided to the internal bank, insurer or NBDT front-line staff who are part of an incentive scheme and deal directly with consumer transactions, and their managers (but not senior managers or directors). While the influence of senior management on lower-level staff should not be underestimated, the risk of harm to consumers from mis-selling is greatest where consumers interact directly with sales staff.

Who would be protected by these options?

Our current thinking is also to cover sales to all "retail" customers (in a way that is broadly consistent with the existing definitions in the FMC Act). This would cover general consumers and most small businesses with assets up to $5 million in the previous two years. This is because the concept of "retail investor" is familiar to most banks and insurers that are subject to regulation under the FMC Act, and avoids introducing a new concept of "consumer" into the Act. We do note however that many insurance contracts are offered on the basis of consumer vs business, so a retail vs wholesale distinction would be new to them. We are still considering this point and may need to revisit this if it poses an issue for industry.

What are the consequences of breaching these obligations?

Civil liability, including an appropriate pecuniary penalty, would attach for non-compliance.

Option 1: A high-level 'fair treatment' conduct standard

This option would involve the setting of a high-level conduct standard in legislation – e.g. to set the expectation that licensed entities should pay due regard to customers' needs and interests and treat customers fairly. This would be implemented in conjunction with Option 1A (a licensing regime for banks, insurers and NBDTs).

Banks, insurers and NBDTs would be required to show what they are doing to meet this general conduct standard. For example, licensing may be used to require them to have the policies, procedures, systems and controls in place to enable them to meet the standard. This option sets the expectation that licensed entities' business model and strategy take customers' interests into account and that they appropriately monitor whether customers' needs are being met.

This approach is intended to form the basis of a broad and flexible conduct regime that could be expanded over time to introduce more specific obligations through future legislative changes or regulations and licence conditions.

Fair treatment may mean that:

- Customers have confidence that they are dealing with firms that place the fair treatment of customers at the heart of their business.
- Customers receive clear, fair and not misleading information and are kept appropriately informed at every point they interact with the business, including during any claim or complaint.
- Institutions target, and customers ultimately receive, products and services that meet the customers' needs.
- Customers do not face unreasonable pressure to retain or change product, switch provider, submit a claim, make a complaint, or make other product or service decisions or changes – but neither are they unreasonably prevented from doing so if

they wish to.

- Customers are provided with products and associated services of an acceptable standard and which perform or operate as firms have led them to expect.
- Firms establish, implement and maintain effective and transparent complaint-handling systems and customers are treated fairly in interactions with such systems.

How this option will address the problem or opportunity

There are a broad range of problems that have been identified and that go to the heart of how financial institutions run their businesses. This option is a broad obligation that will cover an institution's entire business. It is intended to encourage financial institutions to put their customers at the heart of their business. This option provides the basis for a broad and flexible conduct regime, utilising existing regulatory tools that are in the FMC Act. It will provide a general 'direction setting' standard for the overall regime and enable future work to flesh out more detailed requirements – e.g. through regulations or licence conditions – that can be used to address a broad range of problems.

How this option will deliver the objectives

By setting a high-level standard, this option will enable regulations and/or the regulator to require that licensed entities take steps to meet the following objectives of the review:

- Financial institutions are treating customers fairly
- Financial institutions take responsibility for managing conduct risks across the business.
- The imbalance of power between customers and financial institutions is alleviated.
- Conflicts of interest are reduced.

By providing the basis for a broad and flexible conduct regime, this option will also start to deliver the objective of alleviating the imbalance of power between customers and financial institutions.

Option 1A: Licensing regime for banks, insurers & NBDTs

This option would involve introducing a mandatory licensing regime that applies to banks and insurers in respect of their general conduct in relation to retail customers. The licensing obligations would support the overarching obligations and ensure that licensed entities are subject to a greater degree of regulatory monitoring and enforcement, both in respect of the duties and any further obligations that may added under the licence in regulations. This conduct licensing regime will be an additional licence that these institutions will need to hold, but it will be consistent with the Financial Advice Provider regime and the existing licensing framework set out in Part 6 of the FMC Act.

The licence would be supported by further detailed obligations to ensure banks and insurers are properly implementing the overarching duties into their businesses. This would include requirements for licensed entities to have adequate systems and controls to meet the duties. These requirements to have adequate systems and controls to meet the high-level fair treatment standard would extend to the financial institution's intermediaries, including intermediaries that are financial advice providers. This would be achieved through obligations on the intermediary to comply with relevant parts of the institution's systems and controls.

However, we do not think these systems and controls should apply to activities carried out by intermediaries that constitute the giving of regulated financial advice, as this is already regulated through the FSLAA.

The FMA as regulator could seek civil pecuniary penalties if the licensed entity or their intermediary failed to comply with these requirements or with any conditions on the licence imposed by regulations which are stated to be civil liability provisions.

Another option would be to license intermediaries in their own right, however we believe this would be too high a regulatory burden, especially for small non-adviser intermediaries. Financial advice providers (FAPs) are already licensed under the financial advice regime, so requiring intermediaries to obtain another license would create undue complexity and compliance cost.

Who would this option apply to?

We consider that the licensing requirements should apply to banks, insurers and NBDTs but not to their intermediaries at this stage. We do not consider that the same risks of harm arise from these intermediaries as with banks and insurers to justify the regulatory cost of licensing for these entities.

This is because:

- Apart from very large intermediaries with significant market power, the majority of sales incentives are currently created by the product manufacturers (i.e. banks and insurers) who want to sell their products and compete with their competitors. Licensing banks and insurers is therefore likely to capture the majority of the risk.
- Although risk of harm does also exist with intermediaries, licensing these entities would place a disproportionate regulatory burden on them and could create a barrier to entry for new financial service providers (e.g. brokers, advisers, dealer groups), which could reduce access to, and quality of, financial advice, and products and services.
- However, requiring intermediaries to comply with the systems and controls of the financial institution will ensure that intermediaries will also need to manage conduct risks in their business and meet the high-level fairness standard.

We note that <u>all</u> insurers (i.e. life and general) should be licensed. This was also recommended by the IMF in its 2017 Financial Sector Assessment Programme of New Zealand.

Although different levels of risk/harm exist between different types of insurers and different insurance products, we consider that proportionality between different insurers/insurance types can and should be managed through the licensing application process and through conditions of licences. As a general proposition, we consider that all insurers should be subject to the regulatory monitoring and enforcement that comes with licensing as all insurance products can be complex and the same weaknesses in risk management and consumer-focus can exist across all insurers.

How this option will address the problem or opportunity?

Advantages of licensing

Licensing is a comprehensive and flexible framework for ensuring that financial institutions that have the greatest risk of harm address the conduct risks that arise throughout their business. These risks include poor systems and controls to identify, manage and remediate conduct risk, inadequate consideration of customer needs and interests, and conflicts of interests arising from sales incentives).

In addition to the high-level, principles-based duties, licensing also allows further a level of obligations to be placed on licensed entities through regulations (including conditions and eligibility criteria). This provides a greater degree of regulatory control as appropriate. It also provides the regulator with a range of appropriate tools to monitor and enforce compliance with these obligations both at application stage and on an ongoing basis.

Licensing can also be built on easily in the future eg through further licence conditions, application to additional entities, discretion for the regulator in licence conditions and applications.

Disadvantages/risks of licensing

Licensing can impose considerable costs on both the regulator and regulated entities (depending on the licence obligations). These costs need to be weighed against the benefits of a licensing regime.

Licensing can also create barriers to entry for new players. This could have an impact on future opportunities for enhanced competition and the structure of the market.

Another practical issue with licensing that will need to be address is that banks and insurers will be “dual licensed” for conduct and prudential reasons. This could give rise to compliance burden and practical issues for regulators e.g. how revoking an insurer’s licence for conduct reasons could impact on their prudential licence. However, we consider that these issues would be manageable in practice. Australia and the United Kingdom also have dual conduct-prudential licensing regimes and are able to manage any practical issues.

We note further that many banks and direct insurers will likely also hold licences to operate as financial advice providers under the new Financial Services Legislation Amendment Act. Under this legislation, once in force, they will be subject to duties regarding customer interests, conflicted remuneration, and a code of conduct (which includes an obligation to treat clients fairly). Consideration has been given to how the proposed overarching duties interact with these existing obligations and care will be taken to manage the interaction in practice to minimise uncertainty for industry.

How will this option deliver the objectives?

This option enables the other obligations and specific requirements to be implemented. It does so by providing the regulatory tools for effective implementation and enforcement of the other options. By supporting the other options, this option also achieves the following objectives:

- Financial institutions are treating customers fairly.
- The imbalance of power between customers and financial institutions is alleviated.
- Financial institutions take responsibility for managing conduct risks across the business.
- Financial institutions have appropriate systems and controls to manage conduct risks.

Option 1B: Obligation regarding how banks, insurers and NBDTs design incentives

It is intended that this obligation would require banks, insurers and NBDTs to consider the risks and potential harms that their incentives create, and then design and offer their incentives in a way that minimises the risk or is consistent with the overarching fair treatment standard (option 1 above).

Under this option it would be expected that banks, insurers and NBDTs would:

- Identify the incentives they are offering.
- Consider the risks of mis-sales that those incentives create. This includes considering the degree of risk that the incentive creates i.e. the strength of the incentive to sell and the possible harm that could occur from a mis-sale.
- In light of the factors in (2) above, take reasonable steps to reduce those risks
- Implement systems and controls to manage any remaining risk.

By mis-selling we mean (for example):

- Customers being sold products that don't meet their requirements and objectives
- Customers being sold products they can't afford.

This option refers to incentives in the broadest sense and would cover all internal and external remuneration and incentives, including monetary remuneration and non-monetary incentives provided to staff and intermediaries, commissions, soft commissions, bonuses, leader boards, performance management etc.

In practice, for example, this obligation could lead to businesses:

- Reducing the levels of existing commissions offered to intermediaries, for example reducing the existing levels of upfront commissions in the life insurance sector.
- Changing remuneration schemes so that they are not based on sales volumes or values.
- Removing all remuneration and incentive structures based on sales measures for frontline staff and their managers.
- Having an effective risk identification and mitigation process, including regular reviews of remuneration/incentive schemes and the effectiveness of controls, taking into account consumers' interests.
- Collecting sufficient information to be able to properly manage and mitigate risks of mis-selling arising from features of remuneration schemes.
- Strengthening governance arrangements around the design and approval of remuneration schemes.

While the principles-based nature of this obligation would have the advantage of flexibility for entities to design incentive structures that both meet the obligation and are suitable to their individual needs, the downside is the potential lack of regulatory certainty and enforceability. One way to address this is to have this obligation sitting under the overarching fair treatment standard in option 1, and implement the obligation through the licensing regime proposed in option 1A above.

How this option will address the problem or opportunity

Many banks and insurers have remuneration/incentive schemes that can encourage mis-selling. At the same time, there is a lack of effective systems and controls in place to adequately manage these risks. This option will require firms to address these issues.

How this option will deliver the objectives

This option particularly focuses on the objectives relating to conflicted remuneration but also contributes to the broader objectives of the review.

Conflicts of interest are reduced throughout the supply chain of financial products and services

This option partially achieves the objective of reducing the conflicts of interest that exist in the sales process. It does this by requiring firms to design their incentive schemes so they reduce or mitigate conflicts of interest and the risks of mis-selling.

This would be an effective option at managing a range of conflicts and incentive schemes, as the flexibility of this obligation recognises there are a broad range of incentive schemes and many different ways to mitigate conflicts of interest.

While this option is encouraging a broader cultural shift away from rewards based on sales performance, it may not directly address issues with churn in the life insurance sector, which is driven by high upfront commissions. Life insurers may be reluctant to face the disadvantage of being the first to lower high upfront commissions and this option does not require them to. It is not clear what level of upfront commission is low enough to effectively remove the incentive to churn.

Consumers continue to have access to quality financial advice and suitable products and services

Research[11] and overseas evidence[12] indicates that the average consumer is unwilling to pay for financial advice, suggesting that some form of commission is required for the financial advice industry to survive. This option does not directly ban or limit the levels of sales incentives such as commissions, so we consider that it is unlikely to materially reduce consumers' access to financial advice.

Option 2: Prohibit internal and external remuneration and incentives (including soft commissions) based on sales value or volume targets

This option would prohibit banks and insurers, and their intermediaries, from offering remuneration and incentives which are linked to sales volume or value targets, including soft commissions.

An example of a volume or value target based incentive could be a bonus of $5,000 for being in the top 20 per cent of sellers or for selling $5 million worth of insurance policies, while a soft commission could be a paid holiday to Queenstown or a set of luxury steak knives for selling a certain number of policies.

Remuneration and incentives not linked to sales volume or value or soft commissions (e.g. linear or flat line remuneration on the basis of each policy or product sold such as 5 per cent of the value of each policy) would still be available.

[11] See 2018 MBIE/Colmar Brunton survey results in Section 3.3.
[12] See *Relevant overseas experience* section below, where 80 per cent of Singaporeans indicated they were not willing to pay for financial advice.

How this option will address the problem or opportunity

This option works to address the problems identified by prohibiting some of the remuneration structures that increase the conflict of interest – namely volume or value based remuneration or soft commissions.

Under this option, there is a risk that institutions may simply incentivise more sales through other out-of-scope means. However, this risk can be mitigated by implementing the ban alongside Option 1.

How would this deliver the objectives

This option particularly focuses on the objectives relating to conflicted remuneration but also contributes to the broader objectives of the review.

Conflicts of interest are reduced throughout the supply chain of financial products and services

This option delivers on the above objective by removing problematic volume or value based remuneration and incentives and soft commissions. However, as the option only bans certain structures and not all sales based remuneration or incentives, it would not eliminate the conflicts and risk of mis-selling completely. It also does not address the high upfront commissions commonly offered when life insurance is sold.

However, this option does encourage institutions to continue and speed up commitments to remove sales remuneration and incentives and moves towards alternative structures that focus more on serving the needs of consumers and consumer-focused performance measures.

Consumers continue to have access to quality financial advice and suitable products and services

As this option would ban the offering of certain types of sales remuneration and incentives, it will necessarily require restructuring (and compliance costs) of remuneration and incentive structures across the industry. A blanket ban may affect existing business models and innovation more than a principle-based approach where businesses are allowed to determine their own mechanisms to reduce the risks arising from conflicted remuneration. However, as it still allows commissions, it would still sustain the advice industry and thus access to financial advice.

Option 3: Prohibit all internal remuneration and incentive structures linked to sales measures

This option would prohibit banks and insurers from offering any remuneration or incentives based on sales measures to their internal staff (including staff of a related entity such as wholly-owned subsidiaries, given the close ties between such entities).

This option would only apply to internal staff within an entity, not external intermediaries (such as independent advisers) so its scope is not as broad as Option 2. However, it goes further in its application within the internal entity, as it would ban all types of incentives linked to sales, not just sales value and volume.

The rationale for this distinction (not applying to intermediaries) is that the external/ advice channel relies on variable sales remuneration as the predominant form of compensating staff. On the other hand, internal staff can be remunerated through non-sales measures (e.g. salaries and consumer-focused incentives). Prohibiting the main form of compensation in the external/advice channel risks undermining the sustainability of the financial advice sector as well as consumers' access to financial advice.

How this option will address the problem or opportunity

This option would cement in the remuneration and incentive commitments made by banks and some insurers to the FMA and RBNZ, and create a regime for enforcement of breaches. For other institutions, it would work to improve their structures and practices relating to internal staff.

There is a risk that institutions may move to incentivise sales through other means not captured by the ban but which are less visible, especially given that the option applies unevenly to only internal channels. However, this can be mitigated if Option 1 (the duty to take steps to reduce/mitigate risks of mis-selling arising from incentives) is also implemented.

How would this will deliver the objectives

This option particularly focuses on the objectives relating to conflicted remuneration but also contributes to the broader objectives of the review.

Conflicts of interest are managed, reduced, or eliminated throughout the supply chain of financial products and services

This option delivers on the objective to reduce conflicts of interest by prohibiting the use of all sales remuneration and incentive structures for internal (and related entity) sales. This would reduce, to the extent possible, conflicts associated with internal sales based remuneration and incentives and thus reduce the likelihood of mis-selling. However, if applied in isolation this ban would not address sales conflicts in the external channel.

Consumers continue to have access to quality financial advice and suitable products and services

The option would be unlikely to impact the supply and cost of independent financial advice and sales which rely on sales based remuneration and incentives. We note that all banks and some insurers have already implemented this option reducing the overall compliance cost that would arise from implementing this prohibition.

Option 4: Impose parameters around the structure of commissions

Under this option, there would be a cap on the amount or structure of commissions that can be paid to external intermediaries by banks or insurers. There could be explicit limits on the percentage of commission that could be offered to intermediaries, and/or rules around when different types of commissions could be paid. For example, an upfront commission cap of 70 per cent of the annual premium, with a maximum trail commission of 20 per cent over a set period.

A sub-option is that caps would only apply to those selling health and life insurance[13] products. This is detailed in Option 4A.

How this option will address the problem or opportunity

This option would work to address the problems identified, by limiting those structures or levels of commission that create strong incentives for intermediaries to sell 'at all costs' or to sell particular products over others.

If commissions were capped, the rate at which the cap is set would likely become the de facto commission rate offered. This would level the playing field between product manufacturers and significantly reduce the incentive on the intermediary to sell the product that provides them with the highest commission. If all products offer the intermediary the same rate of commission, the intermediary is not incentivised to sell a particular product over another and is more likely to consider which product is best suited to the customer's needs and interests. This would reduce the risk of mis-selling (and therefore the risk of customer harm).

Setting an appropriate cap on commissions would need to be a careful and considered process, and there would likely need to be periodic reviews to ensure the cap is appropriate on an ongoing basis. Setting the cap too high would not reduce the problem of conflicted remuneration. Setting the cap too low may result in some intermediaries not being able to operate sustainably, and this would reduce consumer access to financial advice.

Furthermore, if a commission cap is structured as a percentage of an insurance premium, there is a risk that manufacturers of insurance products could increase their premiums so that the dollar value of the commission does not reduce (although at some point increasing premiums would become price prohibitive for consumers and consumers would not purchase the product).

How will this option deliver the objectives?

This option particularly focuses on the objectives relating to conflicted remuneration but also contributes to the broader objectives of the review.

Conflicts of interest throughout the chain of supply of financial products and services are reduced

By offering commission to intermediaries to sell their products, product manufacturers are incentivising intermediaries to recommend products to customers based on which product will provide the intermediary the most commission rather than which product best serves the customer's objectives and requirements. By capping the commission that regulated entities can offer to intermediaries, this will help to reduce the conflict of interest by levelling the playing field between products.

However, it is possible that rather than reducing the conflict of interest, capping commissions may encourage intermediaries to simply sell more products because they are paid less per

[13] Life insurance here refers to the following insurance products: life insurance, accidental death cover, funeral cover, income protection insurance (including disability income and mortgage repayment insurance), trauma insurance and total and permanent disablement insurance.

product, thereby increasing the incentive to mis-sell products to consumers who these products are inappropriate for.

Consumers continue to have access to quality financial advice and suitable products and services

This option would likely positively impact on the quality of advice, by reducing the incentive to sell products that may not be the product best suited to customers' objectives and requirements.

However, this option would require changes to how banks and insurers structure their remuneration and incentives, which would have compliance costs and risks. For many intermediaries, commissions are how they get their main source of income, as they often do not charge customers for their advice. By capping commissions this could have a significant effect on their ability to continue to operate. If advisers and other intermediaries exit the industry, this would reduce consumer access to advice and suitable products and services.

A blanket approach, such as this, may impact on existing business practices and models more disproportionately than a principle-based approach where businesses are allowed to determine their own mechanisms to reduce conflicts of interest or improve customer outcomes.

Option 4A: impose parameters around the structure of commissions (for the sales of life and health insurance)

This is a sub-option of Option 4, whereby there would be a cap on the amount or structure of commissions that can be paid to external intermediaries selling health and life insurance[14] products only.

Who would this option apply to?

The application of this option to life and health insurers rather than all financial products is in response to the risks created by the high upfront commissions that are commonly paid to intermediaries for the placement of health and life insurance, and the long term nature of the products. High upfront commissions may incentivise intermediaries to recommend consumers switch products in order for the adviser to obtain the high upfront commission. This is called 'churn'. However, this creates a risk that consumers may lose cover for conditions that they have developed in the interim.

General insurance is excluded from this option because the term of the product is usually for shorter periods of time (often one year) and as such, intermediaries do not receive a high upfront commission, followed by trail commissions. Some other financial products are long term products, such as mortgages, however switching products for other financial products does not create the same risk harm to consumers in terms of loss of cover as it can in health and life insurance.

How this option will address the problem or opportunity

Capping the amount or structure of commissions would help to reduce conflicted

[14] Life insurance here refers to the following insurance products: life insurance, accidental death cover, funeral cover, income protection insurance (including disability income and mortgage repayment insurance), trauma insurance and total and permanent disablement insurance.

remuneration that drives churn by limiting the amount of upfront commission able to be paid to health and life intermediaries, thereby reducing the incentive on intermediaries to recommend switching products.

While in some circumstances changing insurers or policies can be beneficial to the customer if they do not have any pre-existing conditions and end up with better value cover, in the life insurance sector, changing insurers or policies can be harmful if a customer loses cover for pre-existing conditions or ends up with cover that costs more over the long term than their previous cover.

As with Option 4 (impose parameters around the structure of commissions), setting an appropriate cap on commissions would need to be a careful and considered process, and there would need to be periodic reviews to ensure the cap remains set at an appropriate level. Setting a cap on upfront commissions too high would result in continued incentives to churn. Setting a cap on upfront commissions too low may result in some intermediaries not being able to operate sustainably, and this would reduce consumer access to financial advice.

Furthermore, if a commission cap is structured as a percentage of the premium, there is a risk that manufacturers of life and health insurance products could increase their premiums so that the commission does not reduce with regulation (although at some point increasing premiums would become price prohibitive for consumers and they would not purchase the product).

How this option will deliver the objectives?

This option particularly focuses on the objectives relating to conflicted remuneration but also contributes to the broader objectives of the review.

Conflicts of interest throughout the chain of supply of financial products and services are reduced

Capping the upfront commission that life and health insurers offer to intermediaries would reduce the conflict of interest that causes churn.

A cap on commissions for intermediaries selling life and health insurance would likely become the de facto commission rate offered by all product manufacturers. As with Option 4, this would level the playing field between product manufacturers and significantly reduce the incentive on the intermediary to sell the product that provides them with the highest commission. If all products offer the intermediary the same rate of commission, the intermediary is not incentivised to sell a particular product over another and is more likely to consider which product is best suited to the customer's needs and interests. This would be expected to reduce mis-selling (and therefore the risk of customer harm).

However, it is possible this may encourage intermediaries to sell more life and health insurance products because they are paid less per product, thereby increasing the incentive to mis-sell products to consumers who these products are inappropriate for.

Consumers continue to have access to quality financial advice and suitable financial products and services

As with Option 4, this option would likely positively impact on the quality of advice, by reducing the incentive to sell products that may not be the product best suited to customers' needs and interests. This could incentivise intermediaries, such as financial advisers, to provide ongoing service and advice about product suitability, and for maintaining good customer outcomes rather than sales performance, thereby improving the quality of advice.

However, this option will require changes to how life and health insurers structure remuneration and incentives, which will have compliance costs and risks, which may make some adviser business models unsustainable. This would reduce consumer access to advice and suitable products and services if advisers exit the industry. A reduction in upfront commissions could also make it harder for new financial advisers to enter the industry. Over time, this would reduce competition and consumer access to advice.

How has consultation affected these options?

Regarding the high-level conduct standard

Consultation in the Options Paper was on a high level duty to consider and prioritise the customer's interests to the extent reasonably practicable. Submitters were relatively evenly split on whether or not they supported this duty. Those that submitted against the introduction of this duty mostly suggested that this was too vague and ambiguous. Some of the submissions that supported the duty also stated that more guidance would be needed in order for the duty to be workable. Many of the submissions mentioned a preference for a standard of fairness rather than prioritising customer's interests, stating that this would maximise consistency with other laws and codes.

Submitters noted that a fair treatment approach is consistent with:

- the IAIS (International Association of Insurance Supervisors) Insurance Core Principles (ICP) that set out international best standards for insurance regulation (ICP 19 provides that "supervisors require insurers and intermediaries, in their conduct of insurance business to treat customers fairly, both before a contract is entered into and through to the point at which all obligations under a contract have been satisfied")
- the new Code of Professional Conduct for Financial Advice Services, Standard 1 requires that "a person who gives financial advice must always treat clients fairly"
- the Insurance Council of New Zealand's Fair Insurance Code (which requires members to act "honestly, fairly, transparently and with the utmost good faith").

With this feedback in mind we have changed our approach to focus on fair treatment and having regard to customers' interests, rather than prioritising customers' interests. The regime that we are proposing will also create the means to provide more certainty as the regime is implemented.

Regarding incentives

Consultation feedback was broadly supportive of the need to respond to the risk of harm that conflicted remuneration and incentives can pose for customers. However, this feedback was often qualified with concerns that some options may undermine and threaten certain business models and reduce access to financial advice. The submissions have also informed the consideration of the potential costs and impacts of banning certain types of remuneration and incentives linked to sales.

A large number of submissions supported regulation taking a principles-based approach, with clearly defined overarching duties complemented by further specific requirements and/or detailed regulatory guidance that conveyed and enforced regulatory expectations of good conduct. There was also a theme in the submissions that regulation could not be one-size-fits all.

Overall, there was more support for the principles-based duties over the more direct interventions such as bans or restrictions on incentives. There was some support for options 2 and 3 but feedback and opposition was also received which either suggested that banning certain types of remuneration was unnecessary or that the same outcome could be achieved with less prescriptive and interventionist approaches such as a duty option. There was considerable opposition from the industry to Option 4, although this was not unanimous. Concerns raised included Option 4 being too blunt an instrument with significant downside risks. Consultation feedback often reiterated the importance of certain types of remuneration in the financial services industry and of the potential for unintended consequences if they were prohibited.

There were also some stakeholder concerns about the uncertainty around what 'good customer outcomes' are, so we have endeavoured to be more specific in our language rather than using this general statement.

Are these options mutually exclusive?

With the exception of Options 4 and 4A which are alternative options, the options are not mutually exclusive – the options could work in combination with each other.

Options 1 and 1B establish overarching standards/requirements for firms and are more outcomes-focused and flexible in their application. Options 1 and 1B could only be effectively implemented in conjunction with option 1A (licensing).

Options 1 and 1B could be supplemented by the more prescriptive options (2, 3 and 4) which are targeted at removing certain forms of remuneration/incentive structures that exacerbate conflicts of interest in the sector.

Options 2 and 3 partially overlap to the extent that they would both prohibit incentives being offered that are based on sales volume or value and soft commissions for in-house staff. However, they differ in that Option 2 applies to both in-house staff and intermediaries while Option 3 goes further but applies exclusively to in-house staff. In this sense, the options could be combined to achieve a greater impact on the counterfactual, considering the different distribution structures of the banking and insurance industries.

Option 4 focusses on the conflicted remuneration caused by differing commissions, while Option 4A focuses on addressing specifically the harm caused by the problem of churn, which the other options less directly address. While Options 4 and 4A are direct tools to address the risks arising from high upfront commissions, Option 1 can also be a general mechanism to address these risks. Options 4 and 4A partially overlap with Option 2, to the extent that they are addressing the problem of conflicted remuneration for intermediaries, but do not overlap with Option 3 which focuses on addressing internal (staff) remuneration.

Have non-regulatory options been considered?

Non-regulatory options are not being considered further at this point in time. The financial sector already self-regulates its conduct through various industry bodies which has helped reduce risk to consumers, but there are gaps. There are ongoing concerns regarding conflicts of interest driving mis-selling despite the existing codes of conduct that govern the members of these industry bodies, and not all industry players have signed up to industry codes. There are inherent conflicts of interest and enforcement difficulties involved in self-regulation of incentive schemes, which would be inconsistent with the key objectives of this review.

Importantly, non-regulatory options to address incentive issues have already been attempted by regulators. The FMA/RBNZ's conduct and culture reports requested extensive information from banks and life insurers, and set clear expectations for firms to remove all incentives linked to sales measures for internal staff and to review commission structures and volume bonuses for intermediaries (noting that high upfront commissions are not considered acceptable). While banks have now committed to removing incentives linked to sales measures for in-house staff, initial indications are the response from the life insurance sector has been mixed, and it is likely that only some insurers will meet these expectations. This indicates that regulatory intervention is now required to ensure all participants comply with these expectations, and to ensure that participants who have already complied do not renege on these commitments if there is no credible threat of regulation.

For Option 4 and 4A in particular, non-regulatory options are unlikely to be successful as there is a first mover disadvantage which disincentivises product manufacturers from removing, lowering or changing the structure of the commissions they offer to intermediaries. Unless all product manufacturers change their commissions at the same time, the first mover will be disadvantaged, as intermediaries will be less likely to sell the products that offer less favourable commissions for them, and the product manufacturer's business will suffer as a result.

Relevant overseas experience

Several countries, including the United Kingdom and Australia, have financial conduct regulation and have also taken a more stringent approach to sales incentives by placing outright bans on some commissions to help align incentives between financial advisers and their clients. However, other countries, like the United States, have stopped short of banning commissions for financial advisers and have instead sought to improve transparency of adviser compensation schemes. We are not aware of other comparable jurisdictions having implemented a duty around the design of incentives.

Across the European Union, and Germany in particular, recent legislation has sought to promote improved advice by creating classes of advisers that are to be compensated only through fees collected from clients to ensure that potential conflicts of interest are mitigated.

While there have been significant changes to regulatory regimes around the globe, using a variety of approaches, there is only limited, and preliminary, evidence about the impact of those changes on consumers.

United Kingdom

The UK Financial Conduct Authority (FCA) has a Treating Customers Fairly initiative which is principles-based approach to regulation. This includes the key principle that firms must “pay due regard to the interests of its customers and treat them fairly”. Firms must also comply with the FCA’s detailed rules and guidance.

Following the Retail Distribution Review in 2013, the FCA banned commissions for advised investment sales. The FCA has also done specific work on non-advice sales incentives and risks to customers from financial incentives[15].

Despite the benefits of removing ‘commission bias’, the change has contributed to some people not being able get the advice they want and need at a price they are willing to pay, especially for those seeking advice in relation to smaller amounts of money.

There is also evidence indicating that the cost of financial advice may have modestly increased, with some investors now paying 0.5 to 1 per cent in ongoing charges compared to pre-RDR trail commissions typically in the range of 0.5 to 0.75 per cent.

Australia

Since 1 July 2010, over AU$128 million has been paid in remediation to consumers by financial services entities as a result of poor conduct in connection with add-on insurance, and almost AU$250 million was paid to almost 540,000 consumers as a result of poor conduct in relation to home loans.

The Future of Financial Advice (FoFA) reforms in Australia banned conflicted compensation arrangements, including commission and volume payments in relation to advice about and distribution of many retail investment products. ASIC’s preliminary analysis of the impacts of FoFA found little impact on the supply of advice and types of services offered. The study did, however, suggest adviser compensation had responded to the legislation, citing a reduction in commissions paid by product issuers, a reduction in fees based on volume of assets under advice, and an increase in fixed fees paid by clients.

In 2015, Australia began a three-year transition period limiting the amount of upfront and trail commissions payable for the sale of life insurance, which will ultimately be capped at 60 per cent up front and 20 per cent trail.

The ARC report also included a recommendation to ultimately reduce the cap on life insurance commission to zero unless there is ‘a clear justification for retaining those commissions’. The Australian Government has signalled that it will be taking action on all of the recommendations in the final report, barring the recommendation of a ban on mortgage broker commissions.

Singapore

In Singapore, financial advisers can be paid through fees or commissions. However, there are some restrictions on life insurance commissions. For all regular premium life products, commissions are to be spread over the premium payment term or six years. First year commissions are capped at 55 per cent of total commissions, and 45 per cent over the following five years.

In 2016, the Monetary Authority of Singapore (MAS) banned short-term product-related incentives in the financial advice industry, and introduced a Balanced Scorecard Framework

[15] See https://www.fca.org.uk/firms/remuneration/remuneration-and-performance-management-sales-staff-sysc-19f, and in particular https://www.fca.org.uk/publication/finalised-guidance/fsa-fg13-01.pdf.

which regulates the distributors of investment products and investment-linked insurance policies, including life insurance. Their scores will impact on the level of supervision and commissions received. However, commissions have not been banned, citing an April 2012 survey in which 80 per cent of respondents said they were not willing to pay an upfront fee for advice.

European Union

The ”Markets in Financial Instruments Directive“ (MiFID) I and II and the ”Markets in Financial Instruments Regulation“ (MiFIR) set behavioural requirements for banks, regulating the compensation of employees, and imposing requirements on offered financial products and disclosure rules. Under MiFID II, commissions or other monetary benefits from any third party in relation to services to clients were banned for firms providing advice on an independent basis (or portfolio management). This does not prevent those who do not provide independent advice from receiving commissions, although member states are allowed to impose additional restrictions in some circumstances.

Germany

Consumers in Germany can select from fee-based advisers or those compensated through commission. To increase transparency about adviser compensation and promote un-conflicted advice, German lawmakers introduced the Fee-Based Investment Advice Act, effective August 1, 2014. The regulation introduces “fee-based investment advice” as a legally protected designation and imposes specific restrictions on those seeking to become fee-only advisers. As the name of the Act suggests, fee-only advisers are prevented from receiving commissions or remuneration from third parties and must receive payment only from clients. Moreover, firms are prevented from setting sales targets for their fee-only advisers that may conflict with the interests of clients.

Netherlands

In 2013 the Netherlands banned all commissions on life insurance policies. Since then, the Dutch Financial Markets Authority reported a slight increase in the quality of advice. However the number of intermediaries in the market has decreased, there has been a decline in the number of people seeking financial advice before purchasing financial products and there is evidence that consumers with low incomes are less likely to ask for financial advice because of the cost of financial advice.[16]

3.2 What criteria, in addition to monetary costs and benefits, have been used to assess the likely impacts of the options under consideration?

The following criteria have been used to assess the likely impacts of the options:

1. Conflicts of interest throughout the supply chain of financial products and services are reduced.
2. Consumers can continue to access high quality financial advice, and suitable financial products and services.
3. Regulatory obligations are proportionate to the harms identified.

[16] *A commission ban for financial advice: Lessons learned from The Netherlands,* Dr Fred de Jong, https://www.researchgate.net/publication/327933069_A_commission_ban_for_financial_advice_Lessons_learned_from_The_Netherlands

4. Regulatory obligations are certain and predictable.
5. Effectiveness in addressing broader conduct risks.

The main issues these options are trying to address are to reduce the conflicts of interest which can lead to mis-selling and consumer harm, while ensuring consumers can still access appropriate financial advice and products. However, the reduction of all conflicts of interest may be at the expense of access to financial advice, so there needs to be an appropriate balance between achieving each of the criteria in the most effective manner.

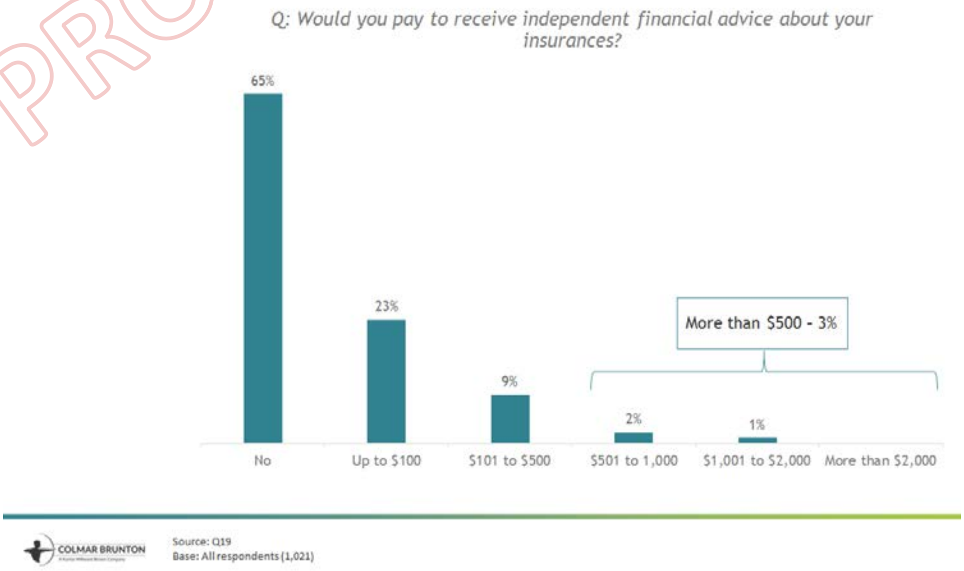
We also want to ensure that regulation is targeted at areas where there is greatest risk of harm (i.e. regulation is proportionate to the identified harms), but this may reduce certainty and predictability of regulation, as achieving proportionality may create some uncertainty – for instance, if a principle-based duty is used.

The discussion of the options and our overall recommendations take this into account, so that the extent to which the options address the problem is weighed against their costs.

3.3 What other options have been ruled out of scope, or not considered, and why?

Ban all conflicted remuneration or commissions

We are not considering a total ban on commissions at this time because there is a significant risk that this will reduce access to financial advice for consumers. A ban on commissions would be likely to make financial advice more expensive and difficult to obtain for the average consumer, as it would probably require consumers to pay upfront fees to obtain advice. The survey results below indicate that most consumers would be unwilling to pay for independent financial advice. A ban is also likely to lead to consequences such as driving all sales in-house, a reduction in the availability of financial advice.



Source: Colmar Brunton survey of insurance consumers, commissioned by MBIE in 2018

Broader conduct options and regime

The time constraints have not allowed us to consider some of the broader options and the full conduct regime that we consulted on in the Options Paper. These options include: design and distribution obligations, product intervention powers and executive accountability. These options will be considered in the next stage of our policy work looking at the conduct of financial institutions.

Section 4: Impact analysis

	No action	Option 1 (A high-level fair treatment conduct standard)	Option 1A (Licensing regime for banks, insurers and NBDTs, including a requirement to have effective systems and controls to meet the high-level fair treatment standard)	Option 1B (Obligation regarding how banks, insurers and NBDTs design incentives)	Option 2 (Prohibit all internal and external remuneration and incentives based on sales value or volume)	Option 3 (Prohibit internal remuneration and incentive structures linked to sales measures)	Option 4 (Impose parameters around the structure of commissions)	Option 4A (Impose parameters around the structure of commissions for the sales of life and health insurance)
Conflicts of interest throughout the supply chain of financial products and services are reduced	0	+ May lead to reduced conflicts of interest through consideration of whether the offering of certain incentives are fair for customers.	++ Provides tools for the FMA to require licensed entities to comply with the law.	++ Requires regulated entities to consider the risks their incentives create take steps to address these risks. However, this may not directly address high upfront commissions, so these may still incentivise churn.	+ Would reduce or mitigate conflicts across external and internal channels. Other forms of remuneration and incentives or commissions may still incentivise mis-selling.	+ Would substantially reduce conflicts in internal channels but leave conflicts in external channels untouched that may still incentivise mis-selling.	+ May lead to reduced conflicts of interest for intermediaries as it may reduce personal benefit gained from offering specific products that offer higher commissions.	+ May lead to reduced or mitigated conflicts of interest for intermediaries through reducing the incentive to churn life and health insurance products but does not address internal incentives.
Consumers continue to have access to high quality financial advice, and suitable financial	0	0 May lead to some restructuring of incentive schemes. However, unlikely to materially impact supply and access to financial advice as	0	0 May lead to some restructuring of incentive schemes. However, unlikely to materially impact supply and access to financial advice as	0 Will require moderate incentive restructuring but reduction in conflicts would also improve quality of advice. Unlikely to materially	0 Will require restructuring of internal remuneration and incentives but only applies internally and leaves independent financial	- - May cause intermediaries, such as financial advisers to leave the industry and therefore reduce consumer access to financial advice.	- - May cause financial advisers to leave the industry and therefore reduce consumer access to financial advice.

products and services		commissions are not prohibited.		commissions are not prohibited.	impact supply and access to financial advice as still permits some sales based remuneration and incentives.	advice untouched. Unlikely to materially impact supply and access to financial advice.		
Regulatory obligations are proportionate to harms identified	**0**	++ A high-level conduct standard can be tailored to entity-specific risks.	+ Licences can be tailored to entity-specific risks, but would increase compliance costs for those entities.	++ Allows regulated entities to devise their own programme for meeting duty. Enables regulators to target compliance for firms depending on the risks of harm.	+ Proportionate as ban focuses on one of the main forms of remuneration and incentives associated with mis-selling and consumer harm, across both internal and external channels.	- Applies to the internal channel which has greater consumer use and coverage, but fails to address external conflicts where harm is also likely to occur. Also applies to flat-line or linear remuneration and incentives for in-house staff which have not been associated with as much harm.	-- We have seen most evidence of harm from incentives in the life insurance sector but do not have the same evidence of harm for other product types. This may place a disproportionate regulatory burden on the entities other than life insurers.	**0** We have seen most evidence of harm from incentives in the life insurance sector, so this is a relatively targeted option.
Regulatory obligations are certain and predictable	**0**	+ A high-level conduct standard provides a framework under which more prescriptive (and certain) requirements can be included.	++ Licensing of higher risk entities provides greater certainty to broad overarching obligation. Creates a means to provide more detailed requirements and for ongoing interaction between the regulator and licensed entities.	+ Entities can comply with obligation by devising compliance programme appropriate for their own business and in line with any specified requirements. May create some uncertainty for smaller players.	++ Provides certainty as to what is not permitted.	++ Provides certainty as to what is not permitted.	++ Provides certainty as to what is not permitted.	++ Provides certainty as to what is not permitted.
Effectiveness in addressing	**0**	++ Provides the basis for	++ Licensing is a	+ May reduce risks	+ May reduce risks	+ May reduce risks	+ May reduce specific	+ May reduce specific

broader conduct and culture issues		a broad and flexible regime under which broader conduct risks to be addressed.	comprehensive and flexible framework for addressing broad conduct risks. Also allows for systems and controls requirement to extend to intermediaries of the licensed financial institution to ensure intermediaries also address conduct risks.	related to sales incentives but not broader conduct issues.	related to sales incentives but not broader conduct issues.	related to sales incentives but not broader conduct issues.	risks related to mis-selling but not broader conduct issues.	risks related to mis-selling but not broader conduct issues.
Overall assessment	**0**	++++++ Significant improvement on the counterfactual.	+++++++ Significant improvement on the counterfactual.	++++++ Significant improvement on the counterfactual.	+++++ Substantial improvement on the counterfactual.	++++ Moderate improvement on the counterfactual.	**0** High uncertainty. Significant risk that this would be worse than the counterfactual.	**0** High uncertainty whether this would result in net positive or negative, as there are significant risks this could reduce access to financial advice.

Key:

++	much better than doing nothing/the status quo
+	better than doing nothing/the status quo
0	about the same as doing nothing/the status quo
-	worse than doing nothing/the status quo
- -	much worse than doing nothing/the status quo

Section 5: Conclusions

5.1 What option, or combination of options, is likely best to address the problem, meet the policy objectives and deliver the highest net benefits?

Preferred options

We recommend the following options:
- **Option 1:** A high-level 'fair treatment' conduct standard
- **Option 1A:** Licensing regime for banks, insurers & NBDTs
- **Option 1B:** Obligation regarding how banks, insurers and NBDTs design incentives
- **Option 2:** Prohibit internal and external remuneration and incentives based on sales value or volume.

Together this package of options should provide a net benefit over the other proposals in ensuring that conduct and culture in the financial sector is promoting good outcomes for all customers and achieving the policy objectives identified in section 2.6. This combination of preferred options represents a significant improvement on the counterfactual, and provides for the greatest effectiveness in addressing broader conduct risks as well as the more specific risks of consumer harm from mis-selling.

The principles-based nature of Options 1, 1A and 1B recognises that every firm's structure is different, and provides flexibility to ensure that this obligation is proportionate and can be applied across a range of business models and incentive schemes. However, this flexibility may also lead to some reduced certainty and predictability. It is therefore supported by a requirement that banks and insurers to have a compliance programme as part of a licensing condition, which is then monitored by the regulator and additional guidance provided as needed (either in regulations or FMA guidance).

Option 2 provides certainty and predictability as it is a prescriptive requirement not to have specific types of incentives, which makes non-compliance easier to identify and enforce. By better aligning the incentives of advice providers and consumers, the costs of regulation and compliance should be reduced.

These options are preferred over more restrictive and far-reaching options to reduce conflicts of interest in the financial sector, such as prohibiting all in-house sales incentives (Option 3) or capping commissions (Option 4 and 4A), which could have significant unintended consequences (i.e. regulatory arbitrage and reduced access to financial advice) and do not address all conflicts of interest and consumer harm from churn. Moreover, Options 1B and 2 together should in practice achieve what Option 3 seeks to achieve, rendering that option unnecessary.

MBIE and FMA would closely monitor conduct and the impact of the preferred options to ensure they are sufficient. If there are other consumer harms occurring from the sales of other types of financial products and services, these can be addressed through the broader financial conduct regime. More prescriptive conduct requirements to address wider conduct issues can also be introduced over time once the foundation for conduct regime is established.

Overall, the net benefits of the preferred options are expected to outweigh the net costs. The table below summarises the expected impact of the proposed changes on regulated parties, regulators, wider government and consumers.

Stakeholder views

The majority of submitters on the *Conduct of Financial Institutions* options paper supported the overarching duty options (including Option 1, 1B) as originally presented in the options paper. A common rationale was that prescriptive bans could be circumvented, so a principles-based approach would be more effective, while enabling innovation and ensuring proportionality. On the other hand, a few submitters (including Cygnus Law and Partners Life) did not support this duty. It was considered that this option would require complex analysis of commission impacts on conduct in particular circumstances. While we did not consult on a licensing or plan-based approach to compliance with this duty, this is similar to the duty in the options paper to have appropriate systems and controls to support good conduct and address poor conduct (which was supported by ICNZ and IFSO). Some insurers noted that such a duty needs to be assessed alongside other existing licensing requirements to identify and manage any overlaps.

We also spoke to the Insurance Brokers Association of New Zealand (IBANZ) about requiring intermediaries, including financial advice providers, to comply with the systems and controls of the financial institution. IBANZ was supportive of not requiring intermediaries to be licensed in their own right under the conduct regime but their preference was to impose obligations under the existing financial advice provider requirements in FSLAA rather than requiring to comply with the systems and controls of the financial institution.

Some submitters (including Insurance Council NZ, IFSO, BNZ and several insurers) favoured a prohibition on target-based remuneration and incentives (the original formulation of Option 2 in the paper). Several submitters favoured this option, but with some limitations, such as carve-outs for non-sales targets or a balanced scorecard approach. On the other hand, a few submitters (NIB, Kensington Swan, Life Direct/Trade Me) considered this option was too specific and might suppress incentives that promote good customer outcomes.

Many submitters (including ICNZ, BNZ, Cigna, NIB) did not support a prohibition on all in-house sales incentives (Option 3). A common view was that this would treat financial entities fundamentally different to other sectors, and cut across standard commercial business approaches. There was also concern that there was no value in drawing a distinction between in-house and external intermediaries. The lack of consistency in application would just shift sales to intermediaries, which could end up driving insurance costs up.

Many submitters (including ICNZ, Insurance Brokers Association NZ, Financial Advice NZ, NZ Bankers Association, Financial Services Council, IAG) did not support a cap on commissions. The general theme was that this would be disproportionate to a problem that is not well-defined, and would be difficult to get right. It was thought this would have unintended consequences, such as increasing profits for providers and moving customers to non-advised sales without any real reduction in insurance costs to consumers.

5.2 Summary table of costs and benefits of the preferred approach

Affected parties *(identify)*	**Comment***: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks*	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*	**Evidence certainty** *(High, medium or low)*
Additional costs of proposed approach, compared to taking no action			
Regulated parties	We expect a medium increase in the costs to regulated parties (i.e. entities specified above in each of the options). These will come in the form of direct costs of restructuring incentive schemes and operational costs of developing and maintaining compliance programmes to comply with Option 1, both on licensed entities and their intermediaries who will be required to comply with the compliance programme. However, these costs will decrease over time and some of the proposals build on or codify what a number of the parties (banks and insurers) are already doing in response to regulators' expectations.	Medium	Low
Regulators	The regulator will see a large increase in costs. This will include costs of monitoring and enforcement of the duties, compliance programme obligations and developing guidance.	High	Medium
Wider government	There is a possibility of greater use of dispute resolution services or courts. There will be a need for related regulators (especially the Commerce Commission and the RBNZ) to increase their engagement with the FMA in the areas of overlapping regulatory remits.	Low	Medium
Consumers	Some of the increased costs to regulated parties may be passed on to consumers in the form of higher interest rates, premiums etc. This is likely to be a relatively small amount spread over a large number of customers.	Low	Low
Other parties	We do not foresee increased costs to other parties.	Low	Low

Total Monetised Cost	Without accurate quantifiable evidence, it is difficult to provide an estimate.	Not known	Not known
Non-monetised costs	We anticipate a medium increase in overall costs, mainly for compliance and enforcement.	Medium	Low

Expected benefits of proposed approach, compared to taking no action			
Regulated parties	Some benefits are likely to result from closer alignment of regulated parties' conduct and consumers' interests.	Low	Low
Regulators	The regulator will have a wider remit and new tools to intervene where there are problems with the conduct of financial institutions.	High	High
Wider government	May contribute to confidence and trust in financial markets. Can lead to reduction of risks and costs associated with systemic failure.	Low	Low
Consumers	We expect fairer treatment of consumers and reduced risks of mis-selling through improvements to conduct and culture which is more focused consumer needs and interests.	Medium	Medium
Total Monetised Benefit	Without accurate quantifiable evidence, it is difficult to provide an estimate.	Not known	Not known
Non-monetised benefits	We anticipate a medium level of benefits from reduced consumer harm and greater confidence in financial markets in the long-term.	Medium	Medium

5.3 What other impacts is this approach likely to have?

While these options are likely to reduce overall conflicts of interest in sales incentives, they will not directly address the issue of high upfront commissions which are incentivising the churn of consumers from one life insurance policy to another. This means that high upfront commissions may continue to be a factor that increases the risk of consumer harm in the long-term.

5.4 Is the preferred option compatible with the Government's 'Expectations for the design of regulatory systems'?

The preferred package of options is compatible with the Government's 'Expectations for the design of regulatory systems'.

This package of options sets out a broad, high-level framework for regulating the conduct of financial institutions, along with mechanisms to address the conduct of intermediaries and a prohibition on certain sales incentives which increase the risk of misconduct.

There are no significant areas of incompatibility, but we note there is further work to design more detailed conduct obligations, regulations and licence conditions to achieve the broad 'fair treatment' conduct standard once the high-level framework is established. This regime is expected to deliver positive outcomes in excess of its costs for New Zealanders over the long-term.

Section 6: Implementation and operation

6.1 How will the new arrangements work in practice?

The preferred package of options will be implemented through amendments to the FMC Act. Regulations will likely also be required to provide further detail of any compliance programme requirements or additional guidance. Consideration will be given to the timing of when the amendments should be brought into effect, taking into account other regulatory changes that are currently taking place and the impact these changes will have on the industry. These changes include the new regime for financial advice under FSLAA, unconscionable conduct amendments in the Fair Trading Act 1986, amendments to the Credit Contracts and Consumer Finance Act 2003, the review of insurance contract law and the Reserve Bank Act review. The implementation of the options may also involve some transitional period to allow regulated parties to make necessary changes to their practices.

The preferred package of options will be enforced by the FMA as the relevant regulator for financial markets conduct. The FMA is an experienced market regulator, although this new conduct regime is a significant extension of its existing remit. It will bring direct regulatory oversight for approximately 100 additional relatively large and complex firms. It will significantly increase the number of regulatory transactions, i.e. changes to programmes, as well as the initial need to review and comment on programmes in addition to developing and providing guidance. This will not be possible within FMA's existing baseline, without significantly reducing its ability to deliver its other statutory responsibilities. MBIE and the FMA are currently working together to review what level of resourcing is appropriate given the increasing remit of the FMA.

The FMA will engage and share information as appropriate with other agencies with an interest in this space. This includes on market guidance, investigation and enforcement matters with the Reserve Bank of New Zealand (RBNZ) and the Commerce Commission. The RBNZ is the prudential regulator for licensed insurers and registered banks and the Commerce Commission is the fair trading and consumer credit contract regulator. The FMA is already experienced at engaging with both of these other agencies and has memoranda of understanding with both (which will likely need updating). Engagement will also take place through the Council of Financial Regulators, on which all of these regulators are members.

6.2 What are the implementation risks?

Some stakeholders raised concerns about certainty of the obligations, particularly standalone duties, but also that an overly prescriptive approach would be unfeasible. Others raised more general concerns about the potential cost of compliance, need for proportionality, risk of regulatory arbitrage and lack of clear evidence of harm.

The proposed options address these concerns by putting the responsibility back on regulated entities to demonstrate how they are going to fulfil the high-level conduct standard and meet the licensing requirements. The approach recognises that there is no one way of meeting the obligations, and provides flexibility for regulated entities to comply while also providing a greater degree of regulatory certainty.

A compliance programme framework is also proportionate, as it allows different levels of obligations to be placed on different institutions depending on the risks associated with them. For example, the evidence of conduct risk in banks and insurers is most clearly established, so higher levels of obligations could be placed on them than, say, non-bank KiwiSaver providers.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
The anticipated impacts will be clearly able to be identified as the proposed approach will involve requiring regulated entities to develop a compliance programme detailing how they will comply with the duties. The FMA as market regulator will therefore be able to monitor to what extent entities are complying with the obligations through the licensing process and conditions. The system-level impacts of the proposals will be monitored primarily by the FMA as part of its role in monitoring and responding to market conduct issues and in enforcing the new conduct obligations. This monitoring and enforcement will also take place within the context of the new financial advice licensing regime, which the FMA regulates, as the conduct of financial institutions and the offering of sales incentives is closely linked to advised sales of financial products. The FMA also conducts regular market surveys and thematic reviews on various issues as and when it considers relevant. These regulatory tools may be used in respect of the new conduct obligations if appropriate. MBIE will provide support to the FMA as appropriate and necessary and monitor the regulatory settings as part of its wider regulatory stewardship obligations. No new, specific data collection activity is proposed at this stage but will be considered if enforcement or compliance issues arise. The baseline for new data to be compared against will be the data collected in the various reports and reviews referred to in Section 2 (Problem definition).

7.2 When and how will the new arrangements be reviewed?
There is no plan to conduct a formal review of the amendments within a particular timeframe. However, the interaction with stakeholders following implementation of the amendments, as well as the FMA's ongoing monitoring and enforcement of the conduct obligations, should assist to uncover whether there are any issues. MBIE regularly evaluates and reviews amendments to the law it administers. The changes could, for example, be reviewed and evaluated two to three years after coming into force (subject to resource constraints). An evaluation or review at this time would allow the changes to have bedded in and any initial impacts to show.