MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HIKINA WHAKATUTUKI

Options paper

Conduct of Financial Institutions

April 2019

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The Ministry of Business, Innovation and Employment (MBIE) seeks written submissions on the questions raised in this document by **Friday 7 June 2019**.

Your submission may respond to any or all of these issues. Where possible, please include evidence to support your views, for example references to independent research, facts and figures, or relevant examples.

Please use the submission template provided at: ***http://www.mbie.govt.nz/financial-conduct***. This will help us to collate submissions and ensure that your views are fully considered. Please also include your name and (if applicable) the name of your organisation in your submission.

Please include your contact details in the cover letter or e-mail accompanying your submission.

You can make your submission by:

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- mailing your submission to:

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

Please direct any questions that you have in relation to the submissions process to ***FinancialConduct@mbie.govt.nz***.

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Contents

How to have your say **3**
List of Acronyms **6**
Foreword **7**
Part 1 - Introduction **8**
Purpose and context of the review 8
Scope of the review 8
Process and timeline 9
How to use this document 9
How we use the term ‘financial institutions’ 9
How we use the term ‘product lifecycle’ 9
Outcomes sought 10
Current situation (status quo) 12
Part 2 – Problems identified **14**
Why regulate financial institutions? 14
Problems at the product design stage 18
Problems at the product distribution stage 19
Problems during product use and ongoing interactions 22
Part 3 – Options **26**
3.1 Initial preferred package of options **27**
3.2 Options for overarching duties **29**
3.3 Options to improve product design **37**
3.4 Options to improve product distribution **40**
3.5 Options relating specifically to insurance claims **47**
3.6 Options for tools to ensure compliance **50**
4 Who should the conduct regulation apply to? **57**
Application of options to banks, insurers and other financial institutions 57
Overlap with existing regulation 59
Entity- vs product-level regulation 61

List of Acronyms

ARC	Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry
CCCFA	Credit Contracts and Consumer Finance Act 2003
CFFC	Commission for Financial Capability
FMA	Financial Markets Authority
FMC Act	Financial Markets Conduct Act 2013
FA Act	Financial Advisers Act 2008
FSLAA	Financial Services Legislation Amendment Act 2019
IFSO	Insurance and Financial Services Ombudsman
IMF	International Monetary Fund
MBIE	Ministry of Business, Innovation and Employment
NBDT	Non-bank deposit taker
RBNZ	Reserve Bank of New Zealand

Foreword

Financial institutions affect all of us in some way. Most of us have a bank account and many of us take out some form of insurance. Banks and insurers are part of the critical infrastructure that is necessary to ensure the wellbeing of the individuals, families and communities in our country.

Given their widespread reach and importance, we need banks and insurers to be creating good outcomes for their customers. Only then can we build a productive, sustainable economy that works for everyone and is fit for the 21st Century.

Recently it has come to light that our financial institutions have not been sufficiently focused on benefitting those individuals who use their services and managing the risk of misconduct within their business. This is apparent in both the bank and life insurer conduct and culture reviews undertaken here by the Financial Markets Authority and the Reserve Bank, as well as the Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Service Industry.

While the situation in New Zealand does not appear to be as bad as it is in Australia it is still clear that some things need to change.

This Options Paper looks at how we might better regulate the conduct of financial institutions. I encourage you to carefully consider the issues presented here and comment on the ideas put forward for addressing them.

I look forward to a public discussion as we work to ensure that conduct and culture in the financial sector delivers good outcomes for all customers.

Hon Kris Faafoi

Minister of Commerce and Consumer Affairs

Part 1 – Introduction

Purpose and context of the review

1. 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.

2. 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).

3. Since then, we have seen growing evidence that the gaps identified in insurer conduct regulation also apply more generally to the conduct regulation of financial institutions.

4. 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 are Australian-owned, so the findings of the ARC have raised questions as to whether the same failings exist here also.

5. The FMA and RBNZ conducted reports into the conduct and culture of banks and life insurers between late 2018 and early 2019. While the reports did not find widespread conduct and culture issues, they highlighted failings in how conduct risk is managed in both the banking and insurance sectors. This increases the potential for more widespread consumer harm in the long-term.

6. This emphasises the need to have a robust regime in place to encourage good conduct, and to enforce corrective measures for misconduct.

Scope of the review

7. In order to allow for more substantial consideration of the range of options available in the conduct space, MBIE has separated insurance contract law and financial institution conduct, to release two simultaneous options papers. Issues related to insurance contract law are outside of the scope of this paper. However, the conduct issues related to the broader insurance

sector (including both life and non-life insurers) have been included in this paper due to the similarities between the issues identified in the FMA and RBNZ's reports on banks and life insurers.

8. The parallel options paper on insurance contract law is available at **mbie.govt.nz/insurance-contracts**.

Process and timeline

9. Submissions on this paper close **Friday 7 June 2019**. Following that, we will review the submissions and make recommendations to the Minister of Commerce and Consumer Affairs, with a view to introduce legislation to Parliament by the end of 2019.

How to use this document

10. We have included suggested questions throughout the document. While we seek answers to these questions, we also welcome any other relevant information that you wish to provide. All paragraphs are numbered for ease of reference.

How we use the term 'financial institutions'

11. When we refer to financial institutions in this paper we are primarily referring to banks and insurers[1]. However, as discussed in section 7, there is a question regarding whether the regime proposed in this paper should apply more broadly to other types of financial institutions – such as KiwiSaver providers, Non-Bank Deposit Takers, lenders etc. The potential to apply the regime more broadly is why we have chosen the general term 'financial institutions' rather than the more specific term 'banks and insurers'.

How we use the term 'product lifecycle'

12. We have used product stages to help us consider when problems arise and the options that will mitigate them. The paper includes discussion of general overarching duties that could apply to financial institutions (also referred to as product manufacturers in parts of this document) at all points in time but also options for duties which would apply at specific points in the product lifecycle.

13. For the purposes of this options paper we have used the term 'product lifecycle' to encompass product design, product distribution, and ongoing product use interactions (including when complaints are made). These stages are described in more detail below.

[1] By insurers, we mean all types of insurers: life, health and general (house, contents, motor vehicle).

14. Product design: The stage at which the product is conceptualised and prepared. This is before the product is distributed.

15. Product distribution: The stage at which the product is ready for sale, and is sold to consumers, whether this is sold by in-house staff (i.e. sales staff directly employed by the financial institution, but not including staff of related entities) or by an intermediary (including third-party advisers, staff of related entities e.g. bank staff selling the bank insurer's[2] product, other insurers, and organisations that arrange group insurance for their employees or members).

16. Product use and ongoing interactions: The stage at which the product has been sold and is in use by the customer. This includes ongoing communications, services, complaints handling and in the case of insurance, claims handling.

Outcomes sought

17. The high-level outcome of this review is to ensure that **conduct and culture in the financial sector is delivering good outcomes for all customers**.

18. This means the product or service is understood by the customer, and is suited to their needs on an ongoing basis. Good conduct and culture is demonstrated where staff in an organisation are encouraged and expected to behave in a way that seeks to achieve good customer outcomes.

19. To achieve the high-level outcome above, we are seeking the following objectives in the banking and insurance sector:

    1) Financial institutions focus on ensuring good customer outcomes over the product lifecycle.

    2) Retain access to financial products and services that promote good customer outcomes.

    3) Alleviate the imbalance of power between customers and financial institutions.

    4) Conflicts of interest are fairly and transparently managed.

    5) Financial institutions take responsibility for managing conduct risks across the business.

20. We will use these outcomes as the high-level criteria for the proposed regime. We consider the main objectives set out in the Financial Markets Conduct Act 2013 (FMC Act) are closely aligned with the outcomes sought in this review. We will also have regard to Treasury's principles for best practice regulation[3].

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[2] A bank insurer is an insurer owned by a bank (or in a group of companies with a bank) and distributing products through the bank.
[3] *https://treasury.govt.nz/information-and-services/regulation/regulatory-stewardship/keeping-regulation-fit-purpose/best-practice-regulation*.

21. At this time, we have not assessed each individual option against the high-level criteria above, as some of the options contained in this paper are exploratory in nature and we are seeking feedback on how the options and specific details will work in practice. We also invite feedback from submitters on the pros and cons of each option and how they might contribute to achieving the above criteria. The regulatory impact analysis will then assess each of the individual options against the high-level criteria and Treasury's principles for best practice regulation.

Current situation (status quo)

The regulators and legislation

22. The FMA and RBNZ are New Zealand's two main regulators of financial markets. The FMA focuses on conduct regulation of some financial market participants while the RBNZ focuses on maintaining a sound and efficient financial system through prudential regulation.

23. However, neither regulator has a direct legislative mandate for regulating the general conduct of providers of core retail banking and insurance products and services. The FMA does have responsibility for enforcing the generic fair dealing provisions that apply to all financial products and services under Part 2 of the FMC Act. However, these provisions are relatively narrow in nature, focusing on: misleading or deceptive conduct, false or misleading representations and unsubstantiated representations.

24. The current conduct regime under the FMC Act focuses on high-risk products such as investment products, with an emphasis on providing sufficient information for informed decisions to be made. However, the regime does not extend into consumer financial services such as retail banking and insurance. The FMC Act is enforced by the FMA.

25. The Financial Advisers Act 2008 (FA Act) is another piece of the conduct 'picture' which endeavours to promote the sound and efficient delivery of financial advice and broker services and encourage public confidence in advisers and brokers. The FA Act has recently been reviewed and the Financial Services Legislation Amendment Act 2019 (FSLAA) introduces a new regime for governing the provision of financial advice. The FA Act is enforced by the FMA.

26. The Credit Contracts and Consumer Finance Act 2003 (CCCFA) seeks to protect the interests of consumers in connection with credit contracts, consumer leases, and buy-back transactions of land. The CCCFA is enforced by the Commerce Commission.

27. General legislation also exists to govern how consumers are treated and how trading entities (including financial institutions) are required to behave, including the:

    - Fair Trading Act 1986
    - Consumer Guarantees Act 1993.

28. Financial institutions must also belong to one of the four approved dispute resolution scheme under the Financial Service Providers (Registration and Dispute Resolution) Act 2008. The dispute resolution schemes contribute to good customer outcomes by providing retail customers with simple and free access to redress for issues relating to financial services, up to set monetary limits. The schemes and the system underpinning them were considered as part of the review of the Financial Advisers Act 2008 (which led to the FSLAA) and so are not considered as part of this work on the conduct of financial institutions.

Industry self-regulation

29. The financial sector also self-regulates to an extent, with a number of industry bodies and industry codes, including:

- The New Zealand Bankers' Association and the Code of Banking Practice
- The Insurance Council of New Zealand and the Fair Insurance Code
- The Financial Services Council of New Zealand and its Code of Conduct
- The Health Funds Association of New Zealand and its Code of Conduct.

30. Some of these bodies have penalties for breaches of their code and a code complaints committee, however membership is voluntary and not all participants in the industry are members of the relevant industry body.

Societal expectations of financial institutions are changing

31. Financial products and services provide significant benefits for those who participate in financial markets but also create the potential for significant consumer harm when things do not go as expected. Since the FMC Act and FA Act came into force society has increased its expectations of financial institutions with increasing scrutiny of the behaviour of financial institutions. There have also been changes in perceived good practice internationally, namely greater scepticism about disclosure providing effective outcomes, and more of an understanding of the behavioural issues that exist in financial services.

32. New Zealand's lack of conduct regulation and supervision of insurance and insurance intermediaries was identified as a gap by the International Monetary Fund in the 2017 Financial Sector Assessment Program review and this gap together with lack of conduct regulation of retail banking was highlighted by the FMA and RBNZ's recent reports on the conduct and culture of banks and life insurers.

33. While the FMC Act remains relevant for its intended purpose there is a need to consider extending the conduct regime into areas where it is evident that there is harm, or risk of harm, to consumers.

34. It is worth noting here that there are currently a number of reviews underway in relation to financial services regulation. These include the FSLAA, the Reserve Bank Act review, the review of insurance contract law, and the review of consumer credit legislation.

35. In addition to the existing regulatory settings there are a number of financial capability initiatives ongoing in New Zealand which aim to improve the financial capability of New Zealanders, mainly through the Commission for Financial Capability (CFFC) and the FMA. While long-term in nature, these initiatives are contributing to improving financial capability of individuals and their understanding and use of financial services and products. While long-term programmes to improve financial capability will not be sufficient on their own to improve customer outcomes, they represent an important means to improving customer's interactions with financial services and products.

Part 2 – Problems identified

Why regulate financial institutions?

Financial institutions have a big impact on individuals and the whole economy

36. Financial institutions, and the products and services they provide, are a critical part of a well-functioning society. Core banking services enable us to easily buy and sell, borrow money and save for the future. Insurance provides cover against large unexpected losses – including things like reinstating damaged housing, providing for dependents if we die unexpectedly and generally reducing the long-term personal impact of set-backs that we might experience. Investment schemes like KiwiSaver help us to save for the future and provide for a comfortable retirement. Financial services are therefore critical for individual and family wellbeing.

37. Financial products and services also have a wider benefit than just for individuals. Financially secure and resilient people contribute to a financially secure and resilient society. Insurance enables communities to recover from natural disasters. Borrowing enables individuals to purchase large assets like houses. Borrowing and insurance together encourage businesses to invest and grow. Savings increase resilience, give individuals greater choices and reduce the need for government to step in when things go wrong.

38. When something goes 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. To achieve good customer outcomes, and maintain faith in our financial system, it is important to ensure high standards of banking and insurance conduct.

Financial services have an inherent challenge – a significant imbalance of knowledge and power between financial institutions and consumers

39. There is a significant general imbalance of knowledge and power between financial institutions and consumers. For instance:

    - The complexity of products, including fees and charges, often makes it difficult to understand the product, its cost and when something has gone wrong.

    - The long-term nature of many financial products and services means consumers may not know something has gone wrong for long periods of time and this delay can compound harm.

- Consumers are offered standard form contracts with very little or no ability to negotiate.
- Consumers have limited drive and resources to enforce a contract.
- It is difficult for consumers to organise themselves as a block to overcome lack of scale.
- Consumers may only have suffered a small, unquantifiable loss from a company breaching its conduct obligations and so it is not worth their while pursuing the company in court.
- Consumers are often unable to tell, or do not check, whether they have received the service they should have or whether a financial institution has followed through on a promise it made.
- Disputes regarding financial matters create financial and emotional pressure on a consumer that can affect the consumer's physical environment (in the case of general insurance claims) and physical and mental health.

40. This underlying problem was one of the 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. For reference, the four observations from the ARC were:

    1. **The connection between conduct and reward:** Misconduct was almost always driven by individuals' pursuit of gain, not just by an entity's pursuit of profit. Advisers became sellers and sellers became advisers.
    2. **The asymmetry of power and information:** There was a marked imbalance of power and knowledge between those providing the product/service and those acquiring it. This led to individuals and financial institutions acting in ways they did because they could.
    3. **The effect of conflicts between duty and interest:** Consumers often dealt through intermediaries. But intermediaries' duty to their clients can conflict with their self-interest.
    4. **Holding financial institutions to account:** Financial institutions that broke the law were not properly held to account. Misconduct will be deterred only if financial institutions believe that misconduct will be detected, denounced and justly punished.

41. This means that there is a significant risk of harm occurring to consumers that (a) goes undetected or (b) if detected is not able to be effectively penalised. This suggests a need for regulation.

There are weaknesses in the governance and management of conduct risks

42. The FMA and RBNZ conduct and culture reviews into both banks and life insurers found weaknesses in the governance and management of conduct risks and significant gaps in the measurement and reporting of customer outcomes. This has led to a lack of focus among financial institutions on developing a sustainable culture that puts customers at the centre of their business. This is a vulnerability that, if left unchecked, has the potential to lead to widespread issues such as poor conduct and poor customer outcomes.

43. While financial institutions and regulators have focused on addressing financial risk following the GFC, insufficient attention has been given to culture and governance (i.e. non-financial) risks until recently. In particular, there has been a lack of focus on how financial institutions govern themselves and their employees, as well as their related entities and intermediaries.

44. For life insurers, they found extensive weaknesses in life insurers' systems and control. They noted that "*across the sector*, *governance and management of conduct risks is weak and there is a lack of focus on good customer outcomes… life insurers have been…not focused enough on developing a culture that balances the interests of shareholders with those of customers*". For example, frontline teams and departments were relied on heavily to manage risk, but lacked understanding of conduct risk, and boards and senior managers were not taking responsibility for managing conduct risks.

45. For banks, they identified weaknesses in the governance and management of conduct risks. The noted that "*banks have started to consider culture and conduct issues, but this work has generally been slow and relatively recent*". For example, all large banks now have committees and councils made up of senior managers to oversee conduct and culture risks. However, the majority of these were relatively new, and some have limited authority. It will take time for these structures to be embedded.

46. These weaknesses leave New Zealand banks and life insurers vulnerable to misconduct and to the issues seen in other jurisdictions. This is a particular concern, as pointed out in the ARC report, because a firm's conduct is ultimately the responsibility of the Board and senior management who set the culture of an organisation. If there is not sufficient Board and senior management attention and direction on conduct, it is unlikely a firm's culture will be aligned to good customer outcomes and the chance of achieving them will be reduced.

Non-regulatory options are insufficient to ensure good conduct

47. Commonly considered non-regulatory options include self-regulation of conduct, comparison websites and self-regulation of quality. As discussed below, it is unlikely that these non-regulatory options are viable ways of sufficiently addressing the problems posed in this paper.

Self-regulation of conduct

48. No one consumer is in a position to be able to evaluate whether a bank is appropriately managing conduct risks in its business. This is illustrated by the fact that the concerns with how banks and life insurers manage conduct risks were not properly identified until the FMA and RBNZ undertook reviews of the conduct and culture of these sectors.

49. The financial sector already self-regulates its conduct. Insurance Council of New Zealand, Financial Services Council, Health Funds Association of New Zealand and New Zealand Bankers' Association each have a code of conduct for their members. However, the current concerns regarding bank and insurer conduct exist despite industry bodies having codes of conduct for their members. This implies that to date, industry bodies have not been sufficiently effective at self-regulating their members' conduct.

50. Self-regulation contains an inherent conflict of interest. Industry bodies are funded by their members and represent their members' interests. This can result in a tendency to create industry codes that meet the needs of those bound by them, rather than those they are meant to protect. It also means that industry bodies are unlikely to be particularly proactive in identifying and penalising poor conduct. The penalties available under self-regulation (in the vicinity of $100,000) are also insufficient to provide a significant deterrent to large financial institutions.

51. The International Monetary Fund, in its 2017 assessment of New Zealand's observance of insurance core principles, considered that New Zealand's developing framework of self-regulation in general insurance and the established dispute resolution services did not sufficiently reduce risks to customers or substitute for regulatory requirements and effective oversight. The ARC has found that leaving the enforcement of industry codes to customers "means, too often, that failure to comply with relevant norms of behaviour… is unrecognised or, if recognised, is not remedied".[4]

Non-regulated comparison websites

52. Comparison websites exist for some types of financial products e.g. life insurance, credit cards and KiwiSaver. They do not currently exist for general insurance. Discussions with companies providing comparison websites for other parts of the financial sector have suggested that the fact there is a small number of general insurers, each with a significant share of the market, means that if any one general insurer does not wish to participate in a comparison website then the website cannot offer a meaningful comparison and is therefore not viable. General insurers have actively discouraged the development of comparison websites, suggesting that regulation might be required before a general insurance comparison website could be established.

53. However, while comparison websites can help at the point of purchase, they cannot inform consumers about their ongoing experiences. Product comparison websites which inform consumers prior to purchase cannot effectively alleviate difficulties that exist after the product has been purchased.

Self-regulation of ongoing quality and service

54. Financial products are complex and are often uniquely defined by the contract – unlike, say, commodities, where the physical product is relatively homogenous. For instance, every insurance policy is slightly different and those differences can be material. Customer outcomes from a financial product are often not fully realised until many years after the product was first purchased.

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[4] Interim Report of the Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, page 292.

55. Financial products therefore often cannot be easily or fully evaluated by the consumer, even after purchase. For instance, it is difficult to know whether an insurer will pay a claim until the policyholder actually makes the claim. Similarly, when an insurance claim is paid it can be difficult for the consumer to know whether the amount was fair. It can be equally hard to evaluate whether a bank has followed through on its promises (e.g. a promotion waiving card fees). Consumers can also struggle to understand whether particular products they are offered are in their interests or not.

56. Even if a consumer does manage to evaluate the quality of the financial product purchased, they are often locked in and find it difficult to switch – for instance, switching between health and life insurers can lead to a loss in cover. Switching between banks involves significant hassle. This makes it difficult for consumers to "vote with their feet" and reduces the incentive for financial institutions to continue to offer a high-quality service and act in the customer's interests after the point of sale.

57. The complexities and differences between products make it much harder to develop an industry-wide quality solution (such as a 'quality standard') for financial products compared to many other products and services – such as relatively homogenous commodities.

Problems at the product design stage

58. Complex financial products and services pose a risk to customers because they can be difficult to understand – increasing the potential for unexpected results and consequences. Having a large number of similar products available can also cause confusion for customers. Finding a way to hear the 'voice of the customer' is critical in the design of products. However, products are sometimes not designed with the customer's needs or suitability in mind.

59. Formal processes for considering customer needs in the product design process is one way of ensuring a focus on customer outcomes. However, there are currently very few regulatory requirements on the design of financial products. These problems are set out in more detail below.

Products are not always designed with good customer outcomes in mind

60. 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]

61. The FMA and RBNZ's review of life insurer conduct and culture found limited evidence of products being designed and sold with good customer outcomes in mind and recommended that new products should be designed to provide good customer outcomes.

62. The lack of customer focus is a problem because it means that products are not designed according to the needs of customers, and therefore not suitable to meet those needs.

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

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

63. 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.

64. 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.

65. 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]

Complexity of financial products limits customer understanding

66. Consumers often do not understand their product or policy due to the complex nature of financial products. Submissions on the Insurance Contract Law Issues Paper show there is a general lack of understanding amongst consumers about their insurance policies or cover.

67. The complexity of financial products leads to an information asymmetry where one party understands more than the other about the product. This creates an inherent vulnerability for consumers, which can be exploited by a company to maximise profits at the expense of customer outcomes.

68. Consumers need to be able to understand what financial products are and how each could apply to their situation in order to make informed decisions about which products to purchase. For example, it is difficult for a consumer to make a decision about a product such as a mortgage if they do not understand the complexities of the different types of mortgages available.

69. It is worth noting here that the FMA and RBNZ's review of bank conduct and culture found that some banks already have product simplification projects underway.

Problems at the product distribution stage

70. Product distribution refers to the process of selling financial products and services to customers, for example direct sales by bank or insurer staff, or through intermediaries (also referred to as third-parties) such as brokers. Products may be distributed with or without financial advice.

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

71. Overall, there is a lack of adequate oversight for how financial products and services are distributed, which increases the risk of poor conduct in the long-term. The changes through the FSLAA will introduce a new regulatory regime governing the provision of financial advice. However, this regulates just one aspect of the sale of financial products. Part 2 of the FMC Act covers sales but is limited to the prohibition of misleading or deceptive conduct.

72. The use of intermediaries (e.g. brokers and third-party advisers) also means that often the sales relationship is not directly between the financial institution and the end customer, diffusing responsibility for customer outcomes. For example, the FMA and RBNZ found that where sales and advice were handled through intermediaries, there was a serious lack of product manufacturer oversight and responsibility for sales and advice, and customer outcomes.

Sales are prioritised over good customer outcomes

73. The FMA and RBNZ reports into bank and life insurer conduct found that banks and life insurers are not sufficiently focused on ensuring good outcomes for their customers. In particular, there are significant gaps in the measurement and reporting of customer outcomes. 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. The reports found that often sales are seen as more important than customer outcomes.

74. Most financial institutions have existing processes in place to guide conversations with customers, and to help staff identify and meet customer needs. However, while some of these processes are described by the financial institutions as focusing on customer needs, they still appear to have the primary goal of selling a product to the customer.

75. When customer outcomes are secondary to the sale of a product, due care is not always taken to ensure that the sale will result in good customer outcomes. This is exacerbated by the knowledge imbalance between salespeople and customers, since financial products are complex and salespeople, in general, have a much better understanding of them than the customer.

76. The ARC into Misconduct in the Banking, Superannuation and Financial Service Industry has found that Australia’s financial sector more generally has been focused on short term profit and sales at the expense of basic standards of honesty. The conduct and culture reviews undertaken by the FMA and RBNZ have identified some similar problems in New Zealand, albeit not as widespread as those in Australia.

Conflicted remuneration encourages the mis-selling of financial products and services

77. Conflicted remuneration occurs where one party (e.g. an in-house staff member or intermediary) is expected to provide a service (such as providing information or financial

advice) to a customer but gets paid for selling a certain financial institution's (bank or insurer) product. In the case above, the customer expects the salesperson or financial adviser to act in the customer's interests, but the bank or insurer incentivises the salesperson or adviser to act in the bank or insurer's interests.

78. Remuneration and incentives (which include monetary and non-monetary commission and other rewards) offered to sales staff and intermediaries are typically highly focused on driving sales, which increases the risk of poor conduct. An example of in-house remuneration is a monetary bonus that is only paid if the sales staff achieves their target of selling 10 individual products a week (such as credit cards, KiwiSaver, and life insurance). An example of a non-monetary (or soft) commission to an intermediary could be qualifying for a trip to Queenstown if an adviser is in the bank or insurer's top 50 advisers by sales volume.

79. The FMA and RBNZ reports also found that even where senior management remuneration was linked to long-term outcomes, the measures mainly related to financial performance or parent-bank considerations rather than customer outcomes or the behaviour of bank staff.

80. When staff or intermediaries are incentivised to prioritise sales over good customer outcomes, this can encourage the mis-selling of financial products, irrespective of whether financial advice is provided. Mis-selling occurs when there is a financial product which is sold to a customer but does not suit their needs. Mis-selling may cause customers to end up with financial products which do not do what they expect them to or cost more than optimal.

81. Remuneration tied to sales targets (either volume or value) 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 avoid being performance managed by their bosses. Criticism from managers about sales performance creates pressure to sell.

82. High up-front commissions can also encourage 'churn', which occurs when customers are sold new replacement products that are not in their best interests so the salesperson can earn the large up-front commission. This was one of the findings of the culture and conduct reports, as well as prior FMA reports, and is particularly an issue in life insurance. In many cases, churn of a life or health insurance policy can place a customer is a worse position – for instance if they lose cover for pre-existing conditions.

83. An additional issue is that different rates of commission are paid for different products – including different rates for products offered by the same bank or insurer – increasing the risk that intermediaries act in their own interests, rather than those of the customer. Large up-front commissions at the time of sale can commonly range from approximately 170% to 210% of first-year annual insurance premiums.

84. Overall, the remuneration structures for bank and insurance staff and intermediaries are highly sales focused. This means there is a high risk of inappropriate sales practices occurring. Despite this, financial institutions (who create the remuneration structures) are not adequately monitoring and controlling this risk. The FMA and RBNZ reports found a lack of investment in systems and processes for measuring and reporting on customer outcomes.

Lack of oversight of intermediaries

85. For financial institutions distributing products through intermediaries (e.g. advisers), communication with customers is often inconsistent and, in some cases, largely left to intermediaries. There is very little monitoring or quality assurance checking of the advice provided by third-party advisers and other communications from intermediaries.

86. 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.

87. 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.

88. 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.

Problems during product use and ongoing interactions

89. The FMA and RBNZ reviews of the conduct and culture of New Zealand retail banks and life insurers and submissions to the Insurance Contract Law issues paper have highlighted a number of problems related to product use and ongoing interactions with customers.

Little post-sale follow up of customer outcomes

90. Both reviews found that 'lag' indicators such as complaints data and satisfaction trends are heavily relied upon by financial institutions for measuring customer outcomes but that such indicators are insufficient on their own as they measure short-term satisfaction rather than long-term customer outcomes, which banks and life insurers were found to be doing very little to monitor or engage with.

91. The overreliance on these 'lag' indicators and low interaction with customers post-sale exacerbates the risk that many insurers are not well-informed about whether and the extent to which customers are actually getting what they need or should be getting out of their products.

92. A consequence of this inattention to customer outcomes is that some products and services are providing poor value and outcomes for customers as a result of inappropriately placed products, changes in customers' situations and customer misunderstandings.

Consumers 'set and forget' their financial products

93. As noted by the ARC and the FMA and RBNZ reviews into banks and life insurers, the complexity and information asymmetry common in financial services makes customers prone to setting and forgetting the financial products and services they use.

94. The low engagement with financial services from customers with a set and forget mind-set exacerbates the risk that financial institutions put their own interests ahead of customer outcomes. Examples of where this can occur and customers outcomes suffer include:

- customers continuing to use legacy bank or insurance products when more modern products offer greater benefits and/or lower costs
- customers having levels of insurance cover which are no longer appropriate due to changes in situation
- customers paying fees or premiums higher than they ought to, due to errors that the customer does not notice.

Systems are not always updated to implement new products/promotions

95. 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.

96. 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.

97. 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.

Insurers have an incentive to underpay claims and sometimes use questionable tactics to settle

98. The nature of contracts for insurance and the imbalance in power between insurers and customers when making claims means insurers can face a financial incentive to underpay claims compared to their fair value. Related to this, there were also concerns voiced in submissions to the Insurance Contract Law issues paper that insurers use questionable tactics to settle some claims such as making initial low-ball offers to attempt to reduce the pay-out.

99. If a customer disagrees with an insurer's assessment of a claim it can be very difficult for the customer to challenge the insurer's decision and enforce their rights under the contract. Disputes with a value of more than $200,000 cannot be taken to the Insurance and Financial Services Ombudsman and have to be taken to the courts. The cost, effort and length of time involved in a court case make it unlikely that a consumer policyholder will take this step. If the consumer does take this step the insurer still has the option to confidentially settle before the case comes before the courts. In this way the insurer can minimise their cost, minimise the negative publicity associated with court cases and avoid the setting of legal precedents.

100. This suggests that insurers have an incentive to under-scope repair works (in the case of general insurance) and make low offers in order to reduce business costs. This is especially true for significant claims or in major events (such as natural disasters) where the insurer stands to lose a considerable sum. These are the very events when policyholders are at their most vulnerable and need the insurer to pay out the full value of what they are owed under the contract.

101. It appears that systematic underpayment has occurred following the Christchurch earthquakes. For instance, one independent claims management company provided MBIE with data from 181 claims that it helped to manage following the Christchurch earthquakes. Across the 181 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. This is an average increase of $432,553 per claim and comes to a total increase of $78,292,148 for these 181 claims. The claims management company that provided the data only took on relatively high value claims that it considered to have a good case for an increase in the settlement amount but this does not take away from the point that these 181 cases suggest a systematic under-scoping of repairs and/or attempted underpayment.

102. In another case, community law aided an insurance customer who experienced significant damage to their property in the Kaikōura earthquake. The customer was offered a final cash settlement of less than 10% of their sum insured under the policy. In that case, the insurer had made a change some years before the Kaikōura earthquake targeting older properties by restricting cover to the present day value before the loss occurred. Though the change to the policy schedule was made unilaterally and without disclosure to the insured, the insurer attempted to argue that the policy had always been for indemnity cover and not for a fixed sum. When the customer requested a review and gave correspondence confirming the original policy was for a fixed amount, the insurer agreed that proper disclosure had not been made and they were entitled to claim the full amount of the repairs. This full amount for the repairs on the customer's scope of works was over 600% higher than the value of the attempted cash settlement by the insurer.

103. Community Law also provided MBIE with details of a case where the insurer both withheld and disregarded for over 6 years engineering advice from the Residential Advisory Service Technical Review Panel that indicated a Christchurch customer's earthquake-damaged property required a new foundation instead of a re-levelling. Evidence was found in communications that the insurer, despite being aware of engineering advice from both the Technical Review Panel and its own engineer from a much earlier date, continued to push for the cheaper option of re-levelling the customer's foundation for years instead of the new foundation that the customer was entitled to. Even after the insurer eventually agreed to a new foundation, they continued to attempt to only provide a finished floor level for the foundation below the government and local authority regulations, despite the customer being entitled to have the standard met under their policy. This example shows issues of underpaying, undue delays of claims handling and the withholding of information.

104. In the case of life insurance, the picture appears to be a little different. The FMA and RBNZ conduct and culture review of life insurers found clear evidence of claims staff in life insurers having a strong focus on good customer outcomes.

105. Related to the incentive for insurers to underpay claims, submissions on the Insurance Contract Law Review identified numerous allegations from a range of stakeholders of questionable pressure tactics by insurers to induce claimants to settle for a lower amount than what they are owed or due. Such pressure tactics include low-ball offers made to claimants after lengthy drawn out claims disputes, threats of strict policy application to deny the claim if the offer is not accepted and situations where claimants are told they have to accept a cash payment where that may not be the case. These tactics can cause further harm and loss where claimants lack access to the legal means to fight or challenge settlement offers or disputes with financial institutions.

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

106. 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.

107. 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.

Part 3 – Options

108. This Part outlines options that aim to address the problems set out in the earlier chapter.

109. The options in this paper are not mutually exclusive, and many of the options can work together (for example the overarching duties).

110. We have divided the options into a number of sections covering overall obligations that would apply at all stages of the product lifecycle and then specific obligations that would apply at Product Design, Product Distribution and Insurance Claims Handling. We include a section on Tools to Ensure Compliance and conclude with options for who the conduct regime should apply to.

111. We are seeking feedback on the drawbacks and benefits of the options identified in each section, and the overall preferred package, in order to inform our recommendations to the Minister of Commerce and Consumer Affairs.

3.1 Initial preferred package of options

112. This chapter sets out our initial preferred package of options to address the problems that have been identified.

General approach to a new conduct regime for financial institutions

113. The general approach is to have a principles-based set of duties. This gives the law flexibility to deal with a wide range of conduct, business models and technology. Such an approach does create some uncertainty in how the law applies in practice and may need to be coupled with more prescriptive regulations. A regime like this requires a proactive regulator that engages with the industry, sets clear expectations and holds institutions to account.

Who the regime would apply to

114. In the first instance we propose applying this package to banks and insurers in their dealings with retail customers. We are considering the case for rolling out this package of options to all those financial institutions that offer similar services to banks and insurers.

Overarching duties to govern conduct

115. To address the broad concern that financial institutions are not sufficiently focused on ensuring good outcomes for their customers, we recommend a set of **overarching duties**. These would apply to all aspects of a financial institution's activities. The proposed overarching duties are:

- A duty to consider and prioritise the customer's interest, to the extent reasonably practicable.
- A duty to act with due care, skill and diligence.
- A duty to pay due regard to the information needs of customers and to communicate in a way which is clear and timely.
- A duty to manage conflicts of interest fairly and transparently.
- A duty to ensure complaints handling is fair, timely and transparent.
- A requirement to have the systems and controls in place that support good conduct and address poor conduct.

116. Directors and senior managers could be personally liable if their entity did not meet these duties.

Measures to address conflicted remuneration

117. To address concerns about product distribution, including **conflicted remuneration and incentives** encouraging the mis-selling of products, we recommend the following measures that would apply to all monetary and non-monetary benefits given to both internal staff and external intermediaries (such as advisers):

- A duty to design remuneration and incentives in a manner that is likely to promote good customer outcomes.
- A ban on target-based remuneration and incentives, including soft commissions (this would apply to both in-house staff and to intermediaries).

Obligation regarding insurance claims handling

118. To address concerns about insurers' conduct in relation to **claims-handling**, we recommend:

- A duty to ensure insurance claims handling is fair, timely and transparent.

Measures to ensure financial products are suitable for customers

119. To address issues with **product design**, such as products being designed without customers in mind or that are not fit-for-purpose, we recommend the following measures:

- A requirement for manufacturers to identify the intended audience for a product and a requirement for distributors to have regard to the intended audience when placing the product.
- Give the regulator the ability to ban/stop the distribution of specific products if they have particularly poor customer outcomes (e.g. specific insurance policies with particularly poor successful claims rates).

120. To address concerns regarding the **lack of oversight of intermediaries** we recommend:

- A duty on manufacturers to take reasonable steps to ensure that the sales of its products are likely to lead to good customer outcomes.

Tools for enforcing the regime

121. To ensure that the requirements and duties above are supported by a **credible and effective enforcement regime**, we recommend:

- Empowering and resourcing the FMA to monitor and enforce compliance.
- A range of monitoring powers, enforcement tools available to the regulator. Tools could include public warnings, stop orders, direction orders, enforceable undertakings and civil liability.
- Strong civil pecuniary penalties to deter misconduct.
- Regular reporting of summary data about the industry – such as remediation activities, complaints and reasons for declined insurance claims etc.

3.2 Options for overarching duties

122. At its core, good conduct means focusing on customers' interests and needs to achieve good customer outcomes. To provide the best chance of achieving good customer outcomes, financial institutions need to focus on customer interests and needs. They need a culture that promotes this and systems and processes that support it.

123. The broad nature of the problems identified and the lack of focus on customer outcomes suggests the need for broad overarching duties to inform and shape an institution's conduct and culture. A feature of an overarching duties regime is that it is a principles-based regime and requires financial institutions to consider how the duties are to be met. Regulators can play an active role in clearly communicating their intentions and expectations.

124. Having overarching duties alone is not sufficient to achieve good conduct, but it is an important step towards ensuring financial institutions are taking these obligations seriously and are accountable for how customers are treated overall. We suggest that these duties should apply to all activities of financial institutions.

125. We consider the FMA's good conduct profile provides an appropriate framework for considering the overarching legal duties that should apply. Overarching duties should incorporate the following factors which form 'good conduct':

- **Culture:** The financial institution acts in the customer's interest, treats them fairly and fulfils its obligations.
- **Capability:** The financial institution has the skills and experience to provide an appropriate product or service.
- **Communication:** The financial institution communicates clearly and proactively.
- **Conflict:** The financial institution manages conflicts of interests fairly and transparently.

- **Control:** The financial institution has appropriate systems and controls to support good conduct and address poor conduct.
- **Accountability:** The financial institution is ultimately accountable for ensuring that their governance structures, control mechanisms and culture support good organisational conduct.

126. The options below set out a number of potential duties intended to achieve good conduct. These duties are not mutually exclusive, and our initial thinking is that all the duties below should apply together.

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

127. In order to deliver good customer outcomes, the financial institution needs to consider and prioritise the customer's interest, treat them fairly and honestly, and fulfil its obligations, to the extent that this is reasonably practicable. This is not intended to be a 'best interest' duty, however it would be expected that where a conflict of interest arises, the interest of the customer should be prioritised. This overarching duty should be at the core of the culture of an organisation and is relevant to all stages of the product lifecycle.

128. This means the financial institution will need to be able to demonstrate that it has done what is reasonably practicable to comply with this duty. A code of practice developed by the regulator or an independent body, in consultation with the industry, may help to provide guidance and greater clarity on what is expected to comply with this duty.

129. By way of illustration, a financial institution meeting this duty might consider things such as how to:

- ensure that its products are designed to be fit-for-purpose for their intended audience,
- present information about its products in a way that is accessible and comprehensible,
- evaluate customer outcomes from particular products and test whether the product is still in the customer's interests after a period of time,
- settle claims promptly and in accordance with the policy (all insurers),
- handle complaints in a fair, timely and transparent manner,
- proactively identify issues that require remediation, and
- proactively contact policyholders after a natural disaster (general insurers).

Pros:

- Increases financial institutions' focus on customer interests and outcomes at every point of the product lifecycle, addressing issues with institutions putting the pursuit of profit above other considerations.
- This duty is principles-based rather than prescriptive, which allows it to be applied flexibly as best fits individual institutions and their circumstances.

Cons:

- There may be a degree of uncertainty about how to comply with such a duty, because its meaning and application may vary in particular circumstances, and similar duties exist in other areas.
- Creates new compliance costs on financial institutions as they take steps to meet the duty.

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

130. The objective of this duty is to ensure that the financial institution has the skills and experience to competently provide a suitable service or product. 'Due care' can refer to exercising a certain degree of caution in taking any action, 'skill' can refer to having the necessary expertise and knowledge to take that action, and 'diligence' can refer to taking active steps and having checks and balances in place to carry out that action properly. For example, financial institutions who are meeting this duty should be training their staff and identifying and addressing any capability gaps among their staff.

131. A similar duty of care currently exists for financial advisers, which requires them to exercise the care, diligence and skill that a reasonable financial adviser would exercise in the circumstances. This option would extend this duty more broadly to financial institutions, regardless of how the products are distributed (i.e. it would apply to all such financial institutions and their staff, and would not be limited to financial advisers).

Pros:

- Encourages financial institutions to assess their own capabilities, and ensure they have the right skills and experience to provide a suitable product or service.
- Encourages financial institutions to continually improve their skills through training and development, and address any capability gaps.
- Increases the accountability of financial institutions by making them legally responsible for ensuring their staff act appropriately, which should increase oversight and internal processes for managing conduct.
- Many financial institutions are already subject to this duty through financial advice regulation so the duty should be well-understood and any additional compliance costs should be minimal.

Cons:

- As the duty is not prescriptive, there may be some initial uncertainty for financial institutions about how to meet this duty.

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

132. Clear provision of information and communication are critical to well-functioning financial markets. This duty is aimed at making financial institutions think about what their customers really need to know, as well as when they need to know it and the best way of communicating it (for instance, customer behavioural biases may affect how customers receive information).

133. The intention is to ensure that customers have the necessary information to help them make informed decisions and to set and manage expectations. This may include taking the circumstances of particular customers into account.

134. This would be a principles-based obligation on financial institutions to actively consider the customer's information needs, and provide the necessary information to the customer in an easily understood and timely manner. A more prescriptive duty (which sets out the exact format or specific information to be disclosed) would not be practical here due to the wide range of products and services offered by different financial institutions. However, some examples of things that a financial institution might consider in meeting this duty include:

- taking into account customers' level of financial sophistication and insights from the behavioural literature about how people process information and make decisions,
- proactively explaining the benefits, risks and limitations of their products and services,
- clearly communicating changes to their products or policies,
- ensuring customers can easily understand the products and services they are receiving, including using customer focused, plain English terms and conditions,
- reaching out to customers following an event that may lead to claims.

Pros:

- Helps to reduce the information asymmetry that exists between financial institutions and consumers, as well as communication breakdowns, and goes some way to mitigating the inherent power imbalance between institutions and consumers.
- Implies an expectation that financial institutions should undertake research into what customers' information needs actually are.
- Encourages financial institutions to provide customers with the necessary information and understanding to make informed decisions, while providing flexibility as to how this is done.
- Industry codes already contain reference to clear and effective communication so responsible financial institutions should already be familiar with and understand how to comply with such a duty.

Cons:

- As the duty is not prescriptive, there would likely be some uncertainty about how to comply with such duties, for example, how to define what is clear and timely communication.
- There may be a lack of consistency in how financial institutions comply with these duties, which could make it difficult for consumers to understand and compare the information they are provided.

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

135. Under this option regulated financial institutions would have a duty to ensure there are systems and controls in place to support good conduct and address poor conduct, for example, by having clear and easy-to-use processes for staff to raise issues and risks, systems for measuring and reporting on customer outcomes, product design and staff training.

136. The objective of this option is to encourage financial institutions to be proactive in identifying and recording issues and risks of poor outcomes resulting from poor conduct that may require remediation, remediating them in a timely manner, and investing in systems for measuring and reporting on customer outcomes. This is important to enable financial institutions to carry out root-cause analysis to detect themes, and confirm that complaints are being resolved satisfactorily and within appropriate timeframes.

137. It is also important for financial institutions to ensure their products operate as intended. This includes having appropriate controls to prevent errors, breaches of approved limits or deliberate misuse of systems and products.

138. For example, financial institutions meeting this duty may consider:

- having a code of conduct and educating staff on what good conduct and culture looks like,
- prioritising investment in systems and processes to proactively identify and record issues that may require remediation,
- using lead indicators to provide insights and positive assurance about customer outcomes,
- putting in place enhanced controls and oversight of higher-risk products and distribution channels, and
- ensuring their Boards are setting clear expectations about the information they require to obtain assurance of good customer outcomes and standards of conduct.

Pros:

- Encourages active investment and continuous improvement in systems for measuring and reporting on customer outcomes, which improves oversight and reduces long-term conduct risks.
- Encourages financial institutions to engage with customers in relation to financial products and services they own.
- Information and data collected could be fed back into internal governance and risk systems and further aid identification of issues and risks, which can improve the ability of financial institutions to identify and deal with issues in a timely manner.
- Businesses which are focused on good customer outcomes should already have appropriate checks and balances in place to manage conduct. This suggests compliance cost should not be overly onerous.
- Makes it easier for a regulator to enforce the law.
- Enables a regulator to take a risk-based approach and to consider different businesses' need for, and ability to implement, systems and controls.

Cons:

- Will increase costs for financial institutions and regulators. This option may also result in significant costs for financial institutions if new infrastructure investment is required. This may be a particular issue for institutions that have grown via acquisition and have retained a number of different legacy systems (such as IT systems).

- May result in a blurring of the distinction between minimum standards and best practice – there is a risk this could operate as a disincentive for financial institutions to strive for higher standards, or conversely lead to over-cautiousness which could inhibit innovation.

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

139. Under this option, there would be a broad duty on financial institutions to manage conflicts of interest fairly and transparently, both between an institution and its customer, and between an institution and related parties (which are relevant to the customer).

140. This duty would be relevant to many parts of the financial institution's business activities, including corporate strategy, product design, product distribution, complaints handling, insurance claims handling, as well as its overall interactions with their customers. For example, conflicts of interest are often caused by a financial institution's own remuneration and incentive structures, but they can also occur when inducements are given by third-parties to the financial institution.

141. The primary objective of this option is to ensure that customer interests are well-served and are aligned with the financial institution's business strategies, and that any arrangements with related parties are transparent.

142. For example, a financial institution meeting this duty may be undertaking actions such as the following:

    - having, implementing, and maintaining an effective conflicts of interest policy,
    - identifying, managing and recording its actual and potential conflicts of interest, this may involve disclosing conflicts to the regulator,
    - disclosing relevant conflicts to customers at the point of sale (for example, any conflicted remuneration), and
    - eliminating conflicts of interest where possible.

Pros:

- Mitigates existing and potential conflicts of interest by requiring financial institutions to actively identify and properly manage conflicts.
- May improve financial outcomes for consumers, by increasing the likelihood that customer interests are prioritised in a transaction and decreasing the likelihood that conflicts of interest are driving poor customer outcomes.
- Allows a more flexible risk-based monitoring and enforcement approach by the regulator.

Cons:

- Fairness is a subjective concept and what is sufficiently 'fair' and 'transparent' could be interpreted differently in various circumstances, which could create uncertainty.
- This duty in isolation does not explicitly require the institution to put the customer's interest first and prioritise this interest where there is a conflict of interest, which may not go far enough in promoting good customer outcomes.

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

143. Under this option, financial institutions would be required to have appropriate systems and controls in place for recording and remedying complaints, and make it easy for customers to raise concerns. This means making the complaints process visible and easy to access and understand. All staff should be aware of the complaints process and be able to either deal with complaints or refer the complaint to the right person or team.

144. Having robust systems for recording and managing complaints will improve the ability to carry out root-cause analysis to detect themes and confirm that complaints are being resolved fairly and within appropriate timeframes. Examples of good practice include:

- recording and analysing all complaints (including those that are quickly resolved) to detect emerging trends,
- producing reports for senior managers or committees to ensure complaints trends and responses are well-understood across the organisation,
- escalating the issue to a team of staff from a different part of the organisation if an issue affects a number of customers (e.g. 10 or more customers),
- reporting issues of a serious nature to senior management and the board,
- developing a consistent and common definition of what a 'complaint' is across the organisation, and
- proactively raising customer and staff awareness of complaint and dispute resolution processes.

Pros:

- Encourages complaints processes to be more customer-focused, visible, accessible and valued by all levels of an organisation.
- Requiring a more systematic approach to complaints handling promotes good decision-making and better understanding of the underlying causes of complaints.

Cons:

- Could result in some costs to firms that may need to adjust their complaints processes and systems to ensure compliance with this duty.
- Fairness is a subjective concept and what is 'fair' and 'timely' could be interpreted differently in various circumstances, which could create greater uncertainty.

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

2	*Do you think the overarching duty for managing conflicts of interest should be general (as it is currently worded) or focus on conflicts of interest that arise through remuneration? What are some examples of conflicts of interest that arise outside of conflicted remuneration and incentives?*
3	*Is a code of practice required to provide greater certainty about what each overarching duty means in practice?*

3.3 Options to improve product design

145. In addition to the overarching duties previously mentioned, below are some options focused on product design. These options aim to alleviate the problems in the product design stage stated previously, that is, products are not always designed with good customer outcomes in mind, poor value products or products that are not fit-for-purpose, and, complexity of financial products limits customer understanding.

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

146. This option would give the regulator the power to ban or stop the distribution of specific products if they have particularly poor customer outcomes (e.g. specific insurance policies with particularly poor successful claims rates).

Pros:

- Creates the ability to stop poor value products being sold, which would mean customers were less likely to be sold products that are not suitable for them.
- Gives more flexibility than an outright ban.

Cons:

- It would be difficult to define exactly which products the ban covers, and could mean that products could be adjusted slightly to get around the ban, but still provide a very similar product.
- There would be a cost involved for financial institutions to revoke the products that are banned, or redirect those customers to other products.

Option 2: Ban certain products

147. This option would involve banning poor value products that provide poor outcomes for customers. For example, products that have been suggested as poor value in the insurance sector include payment protection insurance, add on car insurance, funeral cover, accidental death cover and specified injury cover as these often have limited benefits for customers, or are commonly misunderstood.

Pros:

- Stops poor value products being sold, which would mean customers were less likely to be sold products that are not suitable for them.

Cons:

- Bans are usually reserved for things that are unequivocally bad, which is not necessarily the case here. For poor value products there are a portion of customers for whom these products are useful. An outright ban would mean the customers for whom these products are suitable would no longer be able to purchase them.
- There would be a cost involved for firms to revoke the product types that are banned, or redirect those customers to other products.
- It would be difficult to define exactly which products the ban covers, and could mean that products could be adjusted slightly to get around the ban, but still provide a very similar product.
- It may give customers undue assurance that the products that aren't banned are in their interests.

148. Given the significant cons listed, this is not a preferred option.

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

149. This option would affect both product manufacturers and product distributors.

150. Product manufacturers would be required to articulate the outcomes each product is seeking or the need it is fulfilling and identify the intended audience or target market. They would also be required to identify any significant risks associated with the product, including audiences that the product may be unsuitable for.

151. Product distributors (which may or may not be the same entity as the product manufacturer) would be required to have regard to the intended audience when placing the product. If the distributor chose to distribute the product to someone who fell outside of the intended audience then the distributor would need to be able to demonstrate that in that instance the product was still expected to lead to a good outcome for the customer.

Pros:

- Customers' interests and needs would be taken into account when designing and distributing products.
- Provides some assurance to customers that the product they are being sold is suitable for them.
- Creates a reference point to help firms and the regulator to determine whether customer needs are being appropriately considered during design and distribution.
- This would ensure product sellers are aware of certain categories of customer that the product is not well suited for. This could reduce the problem of mis-selling.

Cons:

- It would create significant costs for financial institutions as they would need to put time and effort into identifying the characteristics of the target audience, outcomes sought, and unsuitable audiences for their products.
- There may be customers who fall outside the identified group the product is designed for but for whom the product is still suitable and who may be discouraged or prevented from buying the product.
- It is still possible for products to be mis-sold, such as if a client meets the product criteria but the product is not suitable for some other reason.
- The process of a distributor determining whether a particular customer fell within the target audience and then choosing whether to sell the product to that customer may constitute financial advice. It is possible that this option could therefore result in all sales of financial products being deemed to be financial advice. This could significantly increase the compliance cost faced by those distributors who do not currently provide financial advice when they sell a product.

4	*Which options for improving product design do you prefer and why? Do you agree with the pros and cons of the options? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?*
5	*If a design and distribution requirement like option 3 were chosen, are there particular products for which this is more necessary than others? If so, please explain what and why.*

3.4 Options to improve product distribution

152. How people or financial institutions involved in the sale of financial products are remunerated influences the way they act and tells them what behaviour is valued. As discussed earlier, conflicted remuneration is problematic and financial institutions need to manage this conflict of interest fairly and transparently to ensure good customer outcomes.

153. Remuneration incentives on bank and insurance salespeople and intermediaries are usually highly sales focused, meaning there is a high risk of inappropriate sales practices occurring. Despite this, financial institutions are not adequately monitoring and controlling this risk.

154. Additionally, involvement of an intermediary does not discharge a bank or insurer's responsibility for good customer outcomes. Financial institutions and intermediaries both need to be responsible for ensuring customers experience good outcomes, but at the end of the day it is the financial institution who holds the contract with the end customer.

155. Some banks and insurers have already acknowledged the need to make significant changes to their incentive schemes, and have started taking steps to reduce or remove sales-based incentives. While these changes by individual financial institutions are positive steps, they may not go far enough to create a sustainable culture of good conduct across the sector.

156. Financial institutions (including directors, management and staff) need to recognise and manage these conflicts and asymmetries, and work constantly to ensure customers are offered products that are best suited to their needs, both at the time of sale and in the long term.

157. We are not considering a total ban on commissions at this time because there is significant risk that this will reduce access to financial advice for consumers, drive all sales in-house and reduce competition in the market. 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.

158. To address the problems related to product distribution, we are considering the options below.

Option 1: A duty to design remuneration and incentives in a manner that is likely to promote good customer outcomes

159. Remuneration structures throughout the financial services industry have often rewarded sales performance and profit, but not non-sales standards, such as compliance, behaviour and customer outcomes.

160. Under this option, financial institutions would be subject to a duty to design any remuneration and incentive structures in a manner that is likely to promote good customer outcomes. In contrast to a direct ban or restriction on incentives, this option puts the onus on financial institutions to design incentive structures with customer interests in mind. This duty focuses on the outcomes of the remuneration and incentive structures, rather than the form. Compared to banning certain types of remuneration or incentive, this option means that institutions cannot just design new incentive structures that have the same effect as a banned form of remuneration.

161. Such a duty could apply to incentives at all levels of an organisation – from remuneration arrangements for senior managers down to incentives for front-line sales staff and commissions for intermediaries.

162. For example, financial institutions could restructure their incentive structures to promote good customer outcomes by paying the servicing or trail commissions to the adviser that is providing the advice, rather than locking this to the original adviser. This may have the effect of incentivising advisers to continuously look after their customers' interests, as well as encouraging new advisers to provide appropriate advice and ensure existing products/services still meet the customer's needs.

163. In order to meet this duty, a bank or insurer should be able to explain why it believes its approach to incentives is aligned to good customer outcomes. This includes the effect that remuneration and incentives have on which services and products are recommended to customers, and how any staff performance benefits are disclosed to and discussed with the customer. This could be assessed against the regulator's expectations of what would sustain good customer outcomes.

Pros:

- A powerful tool to make institutions revise incentive models without the risk of removing incentives that are, in fact, good for customers. To be effective this option would need to be combined with strong monitoring and enforcement.
- Ensures that due weight is given to customer outcomes by requiring financial institutions to design incentives in a way which minimises conflicts of interest.
- Could encourage changes that are already being made by individual financial institutions (to reduce the sales focus of their incentive structures) to be more proactive, consistent across the sector, and focused on good long-term customer outcomes.
- If this duty applied to both intermediaries and in-house, it wouldn't create an incentive for financial institutions to simply shift to in-house sales (or vice versa) to avoid the duty.

Cons:

- May create uncertainty for financial institutions as there would not be a clear cap or measurement that tells them whether they have complied with the duty.
- Creates new compliance costs for financial institutions in assessing how their current remuneration/incentive structures are working to promote good customer outcomes, and perhaps changing their remuneration approach to align with good customer outcomes.

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

164. Target-based remuneration and incentives are monetary and other non-monetary benefits that are directly linked to sales targets, where the remuneration or incentive is only received if the sales target is met. These targets include sales/referral numbers (volume), and sales value. For example, an in-house incentive could be a bonus for signing up 20 customers to the bank's KiwiSaver products. An example of an external/intermediary incentive could be qualifying for a trip to Queenstown if the adviser is in the bank or insurer's list of top 50 advisers by sales volume/value.

165. Under this option, there would be a prohibition on financial institutions offering both in-house and external remuneration and other incentives that are directly linked to the achievement of sales targets which are based on value and volume based targets. However, it would not be a ban on all sales-based remuneration – linear or flat-line remuneration is not included in this option (e.g. remuneration based on 5% of the value of each single product sold would be acceptable, but not extra remuneration or a bonus for hitting a target such as an increase to 10% commission for each product). Remuneration would be provided on the basis of each policy or product sold.

166. This option would apply to both in-house remuneration and incentives (e.g. bonuses to staff for selling a certain value or number of mortgages or insurance policies would be prohibited) and to external remuneration and incentives (e.g. a higher commission rate or gifts/bonuses for selling a certain value or number of mortgages or insurance policies would be prohibited).

Pros:

- This option could remove one of the forms of incentives most likely to lead to bad outcomes for customers and reduces the likelihood that consumers are mis-sold products.
- Encourages institutions to use alternative remuneration and incentive structures that are more focused on customer outcomes.

Cons:

- Likely to require changes to how the industry structures its remuneration and incentives, which will have compliance costs and would affect some business models.
- There are risks that some institutions may try to incentivise more sales through other means, but this can be mitigated by implementing this option alongside the duty regarding design of remuneration and incentives above.

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

167. Under this option, financial institutions would be required to remove remuneration and incentives that are linked to sales measures for internal (in-house) staff, including frontline salespeople and all layers of management. This option would be broader in scope than the ban

on target-based remuneration and incentives because it would prohibit all sales-based remuneration, including rewards and benefits linked to sales for internal staff. This option would apply to internal staff within the financial institution (i.e. the bank or insurer) and its related entities (i.e. wholly-owned subsidiaries which share the same parent company). It would otherwise not apply to external intermediaries, such as advisers, with one exception: it would also apply to internal staff of any related entity of the financial institution (e.g. the sales staff of a bank selling the bank insurer's products would be covered).

168. This option would be a significant step towards ensuring bank and insurer incentive structures are designed and controlled to sustain good customer outcomes. It would also encourage financial institutions to speed up the work they are already doing to remove remuneration and incentives linked to sales.

169. Instead of focusing on sales performance when remunerating staff, more weight could be given to non-sales measures (such as customer satisfaction, productivity, staff behaviour, compliance), which would shift the focus towards measuring performance based on good customer outcomes.

Pros:

- Removes the focus on sales as a performance indicator, which reduces the risk that sales are prioritised over good outcomes and of inappropriate sales occurring.
- Requires financial institutions to be more proactive about how to develop a sustainable culture of good conduct and develop incentive structures based on non-sales measures.

Cons:

- May have unintended consequences for incentive structures, and pressure to sell may still exist in different, less visible forms.
- A blanket approach 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 churn or improve customer outcomes.
- Creates a difference between treatment of in-house and intermediated sales. It would therefore need to be considered alongside an option or options that also address conflicted remuneration in intermediated sales.

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

170. Under this option, the amount and/or structure of commissions that insurers and banks can pay to external intermediaries (e.g. advisers) would be directly regulated. For example, there could be explicit limits on the percentage of upfront and trail commissions that can be earned, and rules around when different types of commissions may be paid.

171. Such structures are already in place in relation to life insurance products in Australia. Australian Securities and Investments Commission has allowed for commissions for life insurance sales to be paid inside set parameters, introducing an upfront commission cap of

80% with a maximum trail commission of 20% from 1 January 2018, with a reduction to 70% upfront and 20% trail from 1 January 2019, and further reduced to 60% upfront and 20% trail from 1 January 2020.

172. Some commission structures can incentivise conduct that is not in the customer's interest. For example, high upfront commissions can incentivise advisers to 'churn' existing customers from one product to another in order to receive another upfront commission. This can drive poor conduct and result in poor customer outcomes.

Pros:

- If well-designed, this option could reduce the likelihood of behaviour that drives poor customer outcomes while still retaining access to financial advice.
- Could encourage advisers to be incentivised for providing ongoing service and advice about product suitability and for maintaining good customer outcomes rather than sales performance.

Cons:

- It is challenging to set the 'right' levels and structures of commissions that strike a balance between promoting customer interests and enabling adviser businesses to continue to operate.
- It is possible this could encourage intermediaries to sell more because they are paid less.
- A blanket approach 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 churn or improve customer outcomes.
- It is possible this may have wider consequences for the industry, such as a reduction in upfront commissions may make it more difficult for new entrants to the industry to operate sustainably, ultimately reducing consumers' access to financial advice.

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

173. Currently, some financial institutions avoid any degree of responsibility for the intermediaries they remunerate. This increases the risk of poor conduct and unsuitable products being sold to customers.

174. We do not consider that product manufacturers should be directly responsible for all the actions of their intermediaries. However, our view is that manufacturers should be accountable for making customer-focused choices about who they use to distribute their products. If manufacturers are aware that a particular intermediary is acting in a way that is likely to lead to poor customer outcomes then the manufacturer should be accountable for how they act on this knowledge. This implies that the manufacturer should have some degree of oversight of its product sales, particularly for non-advised sales.

175. Under this duty the manufacturer would be responsible for taking reasonable steps to know whether the sales of its products are leading to good customer outcomes, and take reasonable

action if they see poor conduct or consider that poor outcomes are likely to result from those sales. For example, if an insurer becomes aware that one of its intermediaries is constantly churning their customers, then a reasonable response might include: reporting the intermediary to the FMA, setting clearer expectations about how products are to be placed and ultimately, if the insurer was concerned that the churning behaviour would continue and was likely to result in poor customer outcomes, stop using that intermediary to distribute its products.

176. Examples of 'reasonable steps' could include, but not be limited to:

- Providing training to sales staff and intermediaries on the manufacturer's conduct expectations and on all aspects of the product before they can be sold
- Undertaking some degree of monitoring and quality assurance of who the customers are, whether the products are suitable, and the outcomes for these customers
- Setting clear expectations about who will communicate what information to customers, and having appropriate checks in place to ensure this occurs.

177. What is reasonable may differ depending on the sales channel for a particular product. For example, advisers (intermediated sales) are already subject to the requirements under the FSLAA to prioritise their client's interest, so the manufacturer would not be expected to take significant steps to oversee the sales of products through those intermediaries. However, it would be expected that a manufacturer undertakes more direct monitoring and reporting of the sales outcomes of non-advised sales. We are interested in feedback on whether this duty should just apply to non-advised sales.

Pros:

- Adds a significant additional check to the sales of financial products and ensure that financial institutions took greater responsibility for how their products are distributed. Inaction would no longer be excusable.
- Requires financial institutions to proactively and regularly consider the sales outcomes of their products.
- Allows firms to tailor their processes according to their needs, allowing for flexibility and innovation.

Cons:

- Imposes compliance costs for financial institutions in developing and implementing new feedback or oversight mechanisms.
- Could be interpreted as a principal-agent duty between the manufacturer and intermediary which could result in an increase in tied arrangements between financial institutions and intermediaries and could give rise to unintended consequences, such as reduced competition in the financial advice market and the phasing out of smaller advice firms.
- What constitutes an appropriate monitoring and feedback mechanism could be relatively subjective.

6	*Which options to improve product distribution do you prefer and why? Do you agree with the pros and cons of the options? Are there other impacts that are not identified – such as unintended consequences or impacts on particular business models? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of the options?*
7	*To assist us in comparing the pros and cons of various options, please provide information about remuneration and commission structures currently in use (i.e. what are common structures, average amounts of remuneration/commissions, qualifying criteria etc.?)*

3.5 Options relating specifically to insurance claims

178. Submissions on the Insurance Contract Law Review and other evidence suggests that insurance claims can often experience long delays (e.g. there are still over 2,000 unresolved claims in Canterbury), that claimants sometimes have their claims significantly underpaid and the use of questionable tactics to induce people to settle claims. These issues can be exacerbated where large-scale events occur (e.g. natural disasters).

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

179. This option is intended to ensure that insurers have fair and transparent claims handling and claims dispute resolution policies and procedures in place. Such a duty aligns with the International Association of Insurance Supervisors' Insurance Core Principle 19.10: "The supervisor requires insurers to handle claims in a timely, fair and transparent manner".

180. This duty is intended to provide a way for the regulator to monitor insurers' claims handling practices and examine any attempts to settle claims for less than the insurer is obliged to settle for.

181. This duty is designed to be flexible enough to take exceptional circumstances into account. For instance, some submitters on the insurance contract law review outlined legitimate reasons why the settlement of some claims was delayed following the Canterbury earthquakes.

182. If this duty were to exist and assuming the FMA were the regulator, the Minister could, under section 20 of the Financial Markets Authority Act 2011, request that the FMA inquire into the conduct of insurers in their settling of claims in specific circumstances (e.g. following a major natural disaster). This would be an effective way to review how such a duty was complied with in exceptional situations.

183. This option could be implemented with remedies such as statutory damages for affected customers. This would give financial institutions further incentives to ensure claims handling is fair, timely and transparent. As an example, the CCCFA allows statutory damages of up to $6,000 to be recovered by each debtor for breaches of certain credit disclosure obligations.

Pros

- Should reduce the extent of any intentional underpayment or delays by insurers.
- The principle-based nature of this duty allows for more flexibility in how insurers comply than more complex prescriptive requirements.
- Allows for different circumstances to be taken into account.

Cons

- New duties will inevitably create new compliance costs for insurers. However, these additional compliance costs will mostly fall on insurers who do not currently have adequate procedures in place.
- The subjective nature of the terms 'fair', 'timely' and 'transparent' may create uncertainty or ambiguity for both insurers and customers. This could be reduced through guidance from the regulator.

8	*What is your feedback on imposing a duty to ensure claims handling is fair, timely and transparent? Do you agree with the pros and cons? Are there other impacts that are not identified? Are there other options that should be considered? Do you have any estimates of the size of the costs and benefits of this option?*
9	*If this option were to be adopted, should an attempt be made to clarify what fair, timely and transparent mean? Why? Why not? What are the benefits and costs of doing so?*

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

184. Another option that could work towards improving the problems identified with claims handling is a requirement for insurers to settle claims within a set period of time, such as two years. This would encourage efficient management and consideration of claims and provide a disincentive for any claims delaying tactics.

185. The period for settling claims would need to balance the nature of insurance and range in complexity of claims with the desire for efficient claims processing. Given that New Zealand is particularly prone to natural disasters, a hard deadline for settling insurance claims would likely need exceptions for circumstances such as large natural disasters where it is not possible to process the claims within the statutory time frame. For cases that do not fall under any exceptions but are still complex and take a long period to settle, it may be appropriate to enable the time period to be extended where both the insurer and customer agree.

186. The usefulness of such an option would be dependent on design issues such as when, and by whom, the exception is triggered. For instance, it could be triggered by a significant event or alternatively, only after the insurer has made reasonable attempts to settle within the time period. The option could be designed with an automatic trigger in legislation or with a third party, such as the regulator, having the authority to determine when the exception would be triggered.

187. To achieve sufficient deterrent effect, consequences for breaching the requirement would need to exist. This could include statutory damages for affected customers, civil pecuniary penalties and/or an infringement offence for breach.

Pros:

- Provides more certainty to customers around settlement of their claims and would improve customer outcomes where claims are processed quicker as a result.
- Hard deadline for claims settlement offers more certainty and clarity than a more principles based duty like handling claims in a 'timely' manner.
- Encourages efficient management and processing of claims and dis-incentivises claims delaying tactics.

Cons:

- The rigid nature of a hard deadline may not be appropriate for certain circumstances such as very complex claims and events generating large numbers of claims.
- Specifying an appropriate exception would be difficult.

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

3.6 Options for tools to ensure compliance

188. This section contains options to contribute to the effectiveness of new conduct obligations.

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

189. Consumers are unlikely to individually or collectively take action against a financial institution that breaches its conduct duties because of information asymmetries, imbalances of power and low knowledge or skills of the law. This suggests that a regulator is required to enforce conduct obligations.

190. Given the current remit of the various financial market regulators in New Zealand we believe that the FMA would be the most appropriate regulator to enforce a conduct regime.

Pros:

- Monitoring and enforcing compliance is likely to increase compliance with the law
- Increased consumer confidence in financial markets and financial institutions
- Retains the current 'twin peaks' model of financial regulation with a clear divide between conduct and prudential regulation.

Cons:

- There is a cost from expanding the remit of any regulator that must be borne by either the government (through taxpayer funding), the industry (through levies), or both.

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

Option 2: Entity licensing

191. Under this option insurers and banks would be required to obtain an entity level 'conduct' licence to operate. This creates an upfront hurdle that must be passed before being able to operate in the market.

192. Some overseas examples of this include:

- Australia: all businesses providing financial services or dealing in financial products in Australia must hold an Australian Financial Services licence covering organisational competence and compliance aspects.
- United Kingdom: financial services providers, investment firms and consumer credit firms have to be authorised by the Financial Conduct Authority. The Financial Conduct Authority considers whether the firm is “ready, willing and organised to comply, on a continuing basis, with the requirements and standards under the regulatory system.”

Pros:

- The guidance available through the licensing process can help an entity understand what is required and expected of it. Without licensing this process needs to occur anyway but is likely to be more drawn out with less clarity. Licensing can therefore create more certainty and less cost for both the industry and the regulator in the long run.
- The issuing of a licence increases the regulator’s ability to enforce the regime because it enables clear expectations to be set up-front and an initial assessment of what an entity is doing to meet its obligations. The provision of information up-front also helps the regulator to monitor the business over time.
- An initial check that financial institutions have the right systems and processes in place to meet their licensing requirements would increase consumer confidence in these financial institutions.
- Through up-front engagement with the regulator, the initial focus would be on getting the right processes in place and preventing harm to consumers, rather than waiting for harm to occur and then punishing it.
- The licensing process would allow the regulator to impose specific conditions and tailor its approach to specific businesses and circumstances.
- Licensing forces a systematic approach to assessing an entity’s conduct controls and management.

Cons:

- Licensing is a costly process for both businesses and the regulator both initially and with ongoing supervision. This cost may feed through to customers.
- Creates a regulatory barrier to entry, which may reduce the ability for small, innovative firms to enter the market and could restrict competition.
- Creates a dual licensing regime with both the RBNZ and the FMA issuing licences (although this is already the case to an extent with existing FMC Act licences). A dual regime is likely to result in some duplication of effort for financial institutions and regulators.
- The threat of not granting a licence is less credible where the financial institution is part of the critical infrastructure of the economy (such as is the case with banks or large insurers).

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

Option 3: Broad range of regulatory tools

193. Under this option, the regulator would be given a broad range of regulatory tools and be able to require financial institutions to do or refrain from certain things. This could be done in combination with, or instead of, licensing.

194. Administrative tools could include:

- public warnings
- stop orders
- direction orders
- court injunctions
- enforceable undertakings.

195. Such administrative tools would need to be combined with civil liability and sufficiently high pecuniary penalties to deter non-compliance.

Pros:

- Provides the regulator with a range of tools for taking enforcement action.
- Consistent with current FMC Act powers that the FMA already has for some participants.
- If used instead of licensing, benefits include:
    - less up front administration time for both the regulator and companies
    - gives the regulator greater flexibility to take a risk-focused approach to prioritising its efforts (although this then creates a risk of missing some problems)
    - avoids the duplication that may occur with a dual licensing regime.

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

Option 4: Strong penalties for non-compliance

196. A credible regulatory regime requires strong but proportionate penalties for non-compliance. This option would create court-imposed civil pecuniary penalties for non-compliance. For example, the FMC Act includes civil pecuniary penalties of the greater of:

- the consideration for the contravening transaction,
- three times the amount of the gain made or the loss avoided, or
- $1 million for individual contraveners or $5 million in any other case.

Pros:

- This would allow the FMA to take a flexible enforcement approach proportionate to the harm caused.

- This ensures consistency with other financial market regulation such as existing penalties under the FMC Act.

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

Option 5: Executive accountability

197. Executive accountability or liability is one way to establish conduct expectations and incentivise compliance by creating the possibility of penalties for individuals. Accountability would set expectations of directors and senior managers and make them personally liable for their entity's endeavours to meet the duties set out in conduct regulation.

198. Financial executive accountability regimes globally tend to have 4 elements:

    1. Require senior management to be capable and competent.
    2. Create clear lines of accountability for monitoring conduct e.g. a particular individual is accountable for ensuring the business complies with certain duties.
    3. Individual penalties for failures to meet accountability standards.
    4. Rules of conduct for senior executives.

199. For instance, executives in Australia are subject to an intensive regime that, among other things, includes requirements to:

    - act honestly
    - work constructively with the regulator and
    - take reasonable steps to ensure that the business complies with its conduct obligations.

200. We note that the ARC has recommended extending Australia's Banking Executive Accountability Regime to cover both prudential and conduct obligations.

201. Executive accountability is not an entirely new concept in New Zealand's financial markets regulation. For instance:

    - The FMC Act contains executive accountability for product disclosure statements. Under the FMC Act, liability currently exists for decisions made but not for steps taken (or not taken) to meet a duty.
    - The proposed amendments to the Credit Contracts and Consumer Finance Act will introduce liability for directors and senior managers of creditors.

202. This option could be achieved in a number of ways. For example, executive accountability for banks and insurers could be lined up with the existing executive liability provisions for disclosure breaches in sections 533-536 of the FMC Act. Under section 534, if an entity has contravened a relevant provision of the FMC Act then the directors of that entity are also treated as having contravened that provision. Defences to directors are provided for under sections 499 to 501 – for example, that the director took all reasonable and proper steps to

ensure that the company complied with the provision. Alternatively, accountability could be achieved by developing a liability regime specifically for banks and insurers – for instance along the lines of the Australian regime noted above. We are interested in views and perspectives on the different approaches to achieving executive accountability.

Pros:

- Creates a very strong incentive for directors and senior managers to ensure and monitor compliance with the law and therefore can ensure that good culture flows from the top down in an organisation.

Cons:

- Can make directors and senior managers more risk averse, which can lead to less innovation and slower decision-making.
- Depending on the form of the accountability regime it could involve significant costs to regulated parties and the regulator to operationalise.
- May discourage current and future directors and senior managers from taking on such roles.

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

Option 6: Require whistleblowing procedures to be in place

203. The FMA and RBNZ found that formal procedures and policies to encourage staff to report conduct and culture issues across the banking and life insurance sectors were not effective and seldom used. In both sector reports, the regulators suggest "whistle-blower policies are not particularly effective in encouraging staff to speak up about issues they may encounter on a day-to-day basis".

204. Well-known and confidential mechanisms for staff to report issues or concerns are important in ensuring healthy conduct in organisations. Under this option regulated financial institutions would be required to have particular whistleblowing procedures. For instance, institutions could be required to:

- have internal procedures and policies for receiving and dealing with information about wrongdoing or misconduct
- regularly publish information internally within the organisation about the internal procedures and policies and how to use them.

205. There could also be an external body where complaints could be taken if individuals felt that issues raised through internal procedures had not been properly considered. Such an external complaints body could, for example, be the regulator. This would also provide the regulator with useful information for monitoring financial institutions.

206. Ways in which this could be established range from a requirement in primary legislation (e.g. similar to the obligations on public sector organisations under section 11 of the Protected Disclosures Act 2000) through to the regulator requiring such systems and procedures through licensing.

Pros:

- Would increase awareness and use of whistle-blowing procedures and policies, leading to better identification of issues and improved culture.
- Would provide the regulator with additional conduct and culture information about the financial institutions.

Cons:

- As all registered banks and most life insurers already have whistle-blowing protections and procedures, the improvements and benefits may be limited.
- Low current use of whistle-blowing procedures suggests that they may not be a particularly effective method of encouraging staff to speak up and challenge conduct issues.

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

Option 7: Require regular reporting about the industry

207. This option would require summary data about the industry to be published regularly. This could include metrics such as statistics on: remediation activities, loss/claim ratios for insurance products, reasons for declined insurance claims, number of complaints etc.

208. There are a number of ways in which this could be done, including requiring financial institutions to regularly publish summary data themselves or requiring the regulator to compile a descriptive report on a regular basis e.g. or quarterly reporting similar to the RBNZ's registered bank dashboard of key statistics.

209. By having information published about specific companies this option would help to inform consumer decision making when choosing a financial institution. The Commerce Commission currently undertakes a similar process with its annual telecommunications market monitoring report under section 9A of the Telecommunications Act 2001.

Pros:

- Improves transparency and public scrutiny of the business of the insurance industry, with a corresponding incentive for financial institutions to improve and maintain their business practices.
- Would improve information held about, and monitoring of, the industry by the regulator so that its resources can be focused on investigation or action on firms that require it most.

Cons:

- Increases compliance costs on the insurance industry of collecting and providing/publishing data and information.
- Could be costly for the regulator to regularly prepare such a report.

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

Option 8: Greater role for industry bodies

210. Under this option we would explore what roles industry bodies could play in the regulatory system. This could take a number of forms from being part of a licensing process through to provision of guidance and support to members. For example, industry codes could be approved and enforced by a regulator. This occurs in Australia and Singapore.

Pros:

- This would give the industry the opportunity to take ownership of their conduct.
- May reduce compliance costs because the codes would be built by those who would have to comply with it.

Cons:

- A more formal role for industry bodies would likely require all financial institutions to be members of an industry body – something that is currently optional and that would involve compliance costs.
- More active involvement in the regulatory process would require a regulator (e.g. the FMA) to supervise the industry bodies.
- A formal role for industry bodies may be difficult to achieve successfully where there are multiple industry associations, as is the current situation.
- Industry bodies are funded by their members and represent their members' interests. Giving such bodies formal regulatory roles can create conflicting incentives and undermine their ability to effectively regulate the sector. Though this may be mitigated somewhat by the regulator enforcing the codes.
- Industry players have vested interests which may result in a tendency to create codes that meets the needs of those bound by them rather than those they are ultimately meant to protect. This may be mitigated somewhat by the codes requiring approval from the regulator.
- The current concerns regarding bank and insurer conduct exist despite industry bodies having codes of conduct for their members. This implies that to date industry bodies have not been sufficiently effective at self-regulating their members' conduct.

211. Given the cons above we do not currently think that expanding and formalising the role of industry bodies will solve the issues raised.

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

Part 4 – Who should the conduct regulation apply to?

212. Financial institutions provide services that are critical for consumers – ranging from general banking and credit and lending services through to various types of insurance. Collectively, financial institutions serve a large and varied customer base. To achieve good customer outcomes, and maintain faith in our banking and insurance systems, it is important to ensure high standards of banking and insurance conduct. With this in mind, the options in this paper should be read as applying to banks and insurers.

213. However, there are many other financial service providers that provide services that are similar to banks and insurers e.g. non-bank KiwiSaver providers. It is important that these institutions also provide good outcomes for their customers. There is therefore a question as to whether some or all of the proposed options should also apply to other financial institutions.

214. Applying the options to banks, insurers and other financial institutions also raises issues of potential overlap between new and existing regulation. This overlap may require certain carve-outs or other mechanisms to deal with the interactions.

215. The following section discusses who the proposed options might apply to and ideas for how to deal with the interactions between new and existing regulation.

Application of options to banks, insurers and other financial institutions

Option 1: Apply preferred package of options to retail banks and insurers

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

217. We consider that the obligations should apply in respect of banks' and insurers' retail, rather than wholesale, customers as this is where the greatest evidence of risk exists and need for customer protection lies. Wholesale customers, by contrast, are larger, generally better

resourced and able to inform themselves and therefore information asymmetries and power imbalances are less likely to arise.

218. Our starting point is that the FMC Act definition of “retail investor” or proposed definition of “retail client” under the Financial Services Legislation Amendment Act should apply in respect of the proposed conduct obligations insofar as they may apply to both FMC Act-regulated financial products (e.g. KiwiSaver) and non-financial products (e.g. insurance, credit). These definitions provide various tests of what is a “wholesale investor” or “wholesale client” e.g. investment in financial products or possession of a certain level of assets. However, we are interested in submitters’ views on the most appropriate definition that should apply.

219. We also consider that while all insurers should be covered by the proposed options, there could be a phased approach to implementation. For example, the options might apply to life insurers in the first instance and then to all insurers in a second phase. This kind of phased approach would allow the FMA to put its initial focus on where the greatest risks of harm have been identified to date (being life insurance through the FMA and RBNZ conduct and culture review of that sector), then to roll the conduct obligations out to the insurance sector more broadly after that.

Pros:

- Focus application of conduct obligations where there is the greatest risk of harm and need to ensure good customer outcomes

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

220. The concerns (lack of systems, extending through to behaviour in some instances) set out in various reports have only been identified at this point in relation to banks and insurers.

221. However, many of the services offered by banks and insurers are also offered by other financial services providers. For example, non-bank deposit takers (NBDTs) also offer lending, transaction and savings services, and there are managed non-bank KiwiSaver and wealth management providers. Under this option, the preferred package of options would apply to all financial service providers that provide similar services to banks and insurers. This includes at least:

- NBDTs
- managed investment scheme (including KiwiSaver) providers
- discretionary investment management services.

Pros:

- Provides an even playing field between financial service providers offering the same services as they will be subject to the same obligations

Cons:

- As there is currently only clear evidence of poor customer outcomes and practices in banking and life insurance, this may impose disproportionate regulatory costs on other financial institutions
- May be costly for FMA to implement conduct reforms across broader sections of the industry, particularly if implemented all at once

222. If this option were to be adopted, it could be implemented in a later phase after banks and insurers. This would also enable lessons to be learnt from the experience of applying the regime to banks and insurers, before rolling it out more widely.

Overlap with existing regulation

223. A new conduct regime for financial institutions would overlap with a number of existing pieces of legislation.

Credit

224. Credit transactions, including credit contracts, and consumer leases, are regulated under the Credit Contracts and Consumer Finance Act 2003 (CCCFA). People or businesses that provide these types of credit arrangements are subject to certain duties under the CCCFA, such as the duty to act responsibly at all times and the Responsible Lending Code.

225. Some of the duties being considered in this paper could duplicate the duties that apply to lenders under the CCCFA. Applying the new overarching duties to lenders could also mean they would be subject to oversight by multiple regulators with different roles, as the CCCFA is monitored by the Commerce Commission and the new overarching duties are most likely to be the responsibility of the FMA.

226. The obligations would also need to take account of the upcoming amendments to the CCCFA e.g. clearer responsible lending requirements and cost of credit caps.

Fair Trading Act

227. A number of the overarching duties could overlap with some of what is currently being considered as part of a package of reforms to the Fair Trading Act 1986. This includes changes around unfair contract terms and unfair conduct e.g. unconscionable or oppressive commercial practices.

Financial Markets Conduct Act

228. A number of the proposed obligations could overlap with requirements in the FMC Act that apply to certain products and services offered by banks, insurers and other financial institutions. For example, managed investment schemes (including KiwiSaver) are subject to fair dealing, disclosure, governance/supervision and certain licensing requirements.

Dual licensing

229. If a new conduct licence were to be created, this would potentially create overlapping or duplicative requirements for financial institutions that required both a prudential licence from the RBNZ and a conduct licence from the FMA. While this is a second order issue to be considered once it has been determined whether licensing is a preferred option, we are interested in comments on the potential implications of dual licensing.

Option 1: Overlay preferred package of options onto existing regulation

230. Under this option, the preferred package of options would apply in parallel with any existing regulation. It is not unusual that financial institutions are subject to more than one regulatory regime or set of obligations that might arise from the same event (e.g. this is already the case with the current prudential and financial markets conduct regimes).

231. While the detail will need to be worked through carefully, we consider that the proposed conduct obligations could be designed so that they are not in conflict with existing regulations (e.g. the CCCFA or managed investment scheme (MIS) requirements) and that careful drafting could instead make them complementary or compatible. This would provide a consistent regulatory umbrella for all conduct taking place within a bank or insurer and allow for a consistent enforcement approach by regulators.

232. To promote further certainty about which regulator will enforce what, the Memorandum of Understanding that currently exists between the Financial Markets Authority and Commerce Commission would likely have to be amended.

Pros:

- Provides a consistent regulatory umbrella for all conduct taking place within a bank or insurer, including a consistent regulatory enforcement approach

Cons:

- May create confusion in practice for financial institutions about which regulatory requirements need to be complied with

Option 2: Carve out overlaps from existing regulation

233. Under this option, overlapping regulatory requirements would be identified and carved out of the proposed new conduct regime. For example, lenders that are subject to obligations under the CCCFA would not be subject to any proposed duties that duplicate the CCCFA. However, to the extent that the duties are not inconsistent or duplicative, the new duties would apply to financial institutions.

234. This means, for example, that a bank that provides credit would not be subject to the new overarching duties in respect of its lending activities to the extent that these duties overlap

with the CCCFA. However, the bank would be subject to the new duties and other proposed measures in respect of all its non-lending activities.

235. We see at least the following overarching duties as potentially overlapping or duplicating the CCCFA regime:

- the duty to consider and prioritise the customer's interest
- the duty to act with due care, skill and diligence
- the duty to pay due regard to the information needs of customers and to communicate in a way which is clear and timely.

236. However, we consider that the duty to have appropriate systems to support good conduct and address poor conduct, and the product design and distribution options do not overlap or duplicate the CCCFA so these duties would apply.

237. Under this approach as well, the Memorandum of Understanding that exists between the Financial Markets Authority and Commerce Commission would likely have to be amended to promote certainty about which regulator will enforce what.

Pros:

- Reduces duplicative regulation and promotes clarity

Cons:

- Could create relatively different regimes for different sets of products offered by financial institutions without clear justification
- May result in an inability for the relevant sector regulator (FMA vs Commerce Commission) to carry out pan-sector work on a specific type of behaviour (e.g. insurance add-ons, incentive selling)
- Any subordination or carve-outs from the proposed conduct obligations could undermine the effective regulation of conduct and the outcomes that we hope to achieve with the proposed reforms. For example, if lending was carved out of the overarching duty to consider and prioritise the customer's interest (due to regulation under the CCCFA), and if a bank were to engage in poor conduct in respect of a mortgage product, then the FMA might have responsibility to consider the bank's system for ensuring good customer outcomes generally, but not the specific conduct which is in question.

Entity- vs product-level regulation

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

238. This would involve imposing broad-based conduct obligations at the entity level to financial institutions. These conduct obligations could also be supplemented by some product-specific regulation where this is needed. For example, a claims-handling duty might apply for insurers as discussed earlier. Obligations would also apply to banks' and insurers' related bodies corporate e.g. subsidiaries.

239. This option represents a shift from the current approach taken to regulation in this general area (for example, the FMC Act and the CCCF Act) which is predominantly to regulate specific products regardless of who provides them.

Pros:

- An entity-approach will require financial institutions to have regard to customer outcomes at all levels of their interactions with customers.

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