



## COVERSHEET

<b>Minister</b>	Hon Dr David Clark	<b>Portfolio</b>	Commerce and Consumer Affairs
<b>Title of Cabinet paper</b>	Financial Markets (Conduct of Financial Institutions) Amendment Bill: Further Policy decisions and regulations	<b>Date to be published</b>	16 March 2022

### List of documents that have been proactively released

<b>Date</b>	<b>Title</b>	<b>Author</b>
9/2/2022	<i>Financial Markets (Conduct of Financial Institutions) Amendment Bill: Further Policy decisions and regulations</i>	<i>Office of the Minister of Commerce and Consumer Affairs</i>
9/2/2022	<i>Cabinet Economic Development Committee – Minute of Decisions [DEV-22-MIN-003]</i>	<i>Cabinet Office</i>
9/2/2022	<i>Regulatory Impact Statement: Financial Markets (Conduct of Institutions) Amendment Bill – Further policy decisions</i>	<i>MBIE</i>

### Information redacted

**NO**

Any information redacted in this document is redacted in accordance with MBIE's policy on Proactive Release and is labelled with the reason for redaction. This may include information that would be redacted if this information was requested under Official Information Act 1982. Where this is the case, the reasons for withholding information are listed below. Where information has been withheld, no public interest has been identified that would outweigh the reasons for withholding it.

## In Confidence

Office of the Minister of Commerce and Consumer Affairs

Chair, Cabinet Economic Development Committee

## Financial Markets (Conduct of Institutions) Amendment Bill: Further policy decisions and regulations

### Proposal

- 1 This paper seeks policy approval for:
  - 1.1 amendments to be made to the Financial Markets (Conduct of Institutions) Amendment Bill (**the Bill**) via a supplementary order paper (**SOP**);
  - 1.2 regulations to be made under the Bill, including to regulate sales incentives based on volume or value targets.

### Executive Summary

- 2 The Bill represents a fundamental evolution of the regulation of the retail banking and insurance sectors. It introduces a conduct licensing regime for banks, insurers and non-bank deposit takers (collectively, **financial institutions**), and aims to ensure that these financial institutions treat consumers fairly.
- 3 The Bill was reported back to the House in August 2020 and is currently awaiting completion of its second reading. Following select committee report back, my officials consulted on outstanding aspects of the conduct regime through two discussion documents [DEV-21-MIN-0063 refers].
- 4 One outstanding issue is that the Bill imposes requirements on financial institutions to train and manage or supervise any intermediaries (third parties involved in the provision of financial products and services), in order to ensure fair treatment of consumers. Stakeholders have raised concerns about these requirements, including that the obligations are too broad, unworkable, or duplicate the new regulatory regime for financial advice.
- 5 Following public consultation and further advice from officials, I propose that an SOP address these concerns by limiting the scope of intermediaries covered by the Bill and by amending the obligations that apply to financial institutions in respect of their intermediaries to be more flexible and less prescriptive.
- 6 In order to address other outstanding issues, I also propose that the SOP will make amendments to the Bill to ensure that the Lloyd's insurance market is treated appropriately, and to ensure financial institutions consider the potential for consumers to be in vulnerable circumstances when developing their fair conduct programmes.

- 7 I also propose to make regulations under the Bill to implement Cabinet's policy decision in September 2019 to regulate sales incentives that are based on volume or value targets [DEV-19-MIN-0237 refers].

## Background

### *Summary of the Bill*

- 8 The Bill was reported back to the House on 7 August 2020 and is awaiting completion of its second reading. The Bill gives effect to previous Cabinet decisions regarding the creation of a new conduct licensing regime for financial institutions [DEV-19-MIN-0237 refers].
- 9 The new regulatory regime contained in the Bill is principles-based, intending to drive positive industry behaviour change to ensure the fair treatment of consumers. It is not a rules-based regime which focuses on prescribing how outcomes must be achieved. It needs to have a high degree of flexibility as it will apply to a range of financial institutions and the diverse range of business models and distribution arrangements used by those institutions.
- 10 The Bill responds to reviews by the Financial Markets Authority (**FMA**) and Reserve Bank of New Zealand into the conduct of banks and life insurers, which identified that these institutions lack focus on good customer outcomes, and had serious weaknesses in their internal systems and controls, creating real risks of widespread harm to consumers if left unchecked. The COVID-19 pandemic has also highlighted the importance of fairness and for financial institutions to consider consumers' changing needs and interests.
- 11 Under the Bill, financial institutions will be required to treat consumers fairly (the **fair conduct principle**), and must establish, implement and maintain effective fair conduct programmes to ensure that they comply with the principle. They will be required to be licensed in respect of their conduct towards consumers, and the FMA will monitor and enforce the regime.
- 12 The FMA and Reserve Bank reviews identified that sales incentives were driving conflicts of interest and risking the sale of unsuitable financial products to consumers. Accordingly, financial institutions and their intermediaries will be required to comply with regulations regarding sales incentives. Cabinet has previously agreed to regulate sales incentives based on volume or value targets [DEV-19-MIN-0237 refers].

### *Public consultation*

- 13 In April 2021, Cabinet approved the release of two discussion documents to seek feedback on outstanding aspects of the new conduct regime: firstly, the treatment of intermediaries under the new regime; and secondly, regulations to support the new regime [DEV-21-MIN-0063 refers].
- 14 MBIE received 70 responses from a range of interested parties. Submitters included banks, insurers, non-bank deposit takers, intermediaries such as financial advisers and insurance brokers, law firms and consumer advocates.

Most submitters were positive about the regime and its objective to ensure the fair treatment of consumers, but had differing views about the best ways to achieve the policy objectives, particularly in relation to intermediaries. In terms of regulations, the majority of industry submitters considered that no further regulations were required, preferring guidance from the FMA rather than further prescription. Consumer groups strongly supported the development of further regulations.

- 15 Following submitter feedback on the discussion documents and further advice from officials, I am proposing changes to the Bill that will require amendment through an SOP at the Committee of the whole House stage, as well as the making of regulations to support the operation of the new regime.

### **Supplementary order paper**

- 16 I am seeking Cabinet approval on the following changes that would need to be made to the Bill by SOP. My officials have also identified other minor or technical matters that will be addressed in the SOP but which are within the existing Cabinet policy approvals.

*I propose to amend the obligations that apply in respect of intermediaries*

- 17 Financial institutions (particularly in the insurance sector) frequently sell or distribute products and services through intermediaries. Industry stakeholders have been concerned about the scope of the Bill's provisions relating to intermediaries since the Bill was introduced, and have remained concerned following select committee report back.
- 18 One concern raised by stakeholders is that the Bill as currently drafted requires financial institutions to train and 'manage or supervise' the conduct of independent third parties. I agree that these obligations are too prescriptive and may lead to undesirable structural changes in the market, including intermediaries reducing the number of institutions they work with (in order to not have to comply with requirements stemming from a number of different conduct programmes). This could reduce competition and consumer choice.
- 19 The discussion document released earlier this year proposed amendments to the Bill to address the concerns raised, including by narrowing the obligations that apply to financial institutions in respect of their intermediaries. Having considered feedback and advice from officials, my proposed amendments are guided by the following principles:
- 19.1 Financial institutions are responsible for whether or not consumers are experiencing fair outcomes from their financial products and services, including whether they are treated fairly, regardless of the distribution channel used.
- 19.2 A financial institution's responsibility for consumer outcomes is ongoing and covers the full product lifecycle: from designing the product and setting up a distribution channel, to post-sales interactions and any ongoing service and advice to consumers.

- 19.3 Financial institutions should take a proportionate risk-based approach when designing systems and controls to oversee distribution arrangements. For example, they should take into account the nature of the services and products being offered, and the type of any intermediaries that are involved (including whether they are already regulated under the Financial Services Legislation Amendment Act 2019 (**FSLAA**)) and the nature of their involvement.
- 19.4 In relation to intermediated distribution channels, a financial institution's responsibility for overseeing third-party distribution arrangements should be at a general/collective level, not the level of each individual consumer interaction (e.g. interfering with financial advice).
- 20 To reflect these principles, I intend that the Bill's provisions will be more flexible and less prescriptive. I propose to remove the obligations on financial institutions that currently require them to train and manage or supervise intermediaries. However, financial institutions will continue to have high-level obligations to have effective policies, processes, systems and controls to:
- 20.1 ensure their distribution arrangements (including the distribution of products and services through intermediaries, and including arrangements for post-sales servicing activities and after-sales care) comply with the fair conduct principle;
- 20.2 monitor whether their distribution arrangements are meeting the fair conduct principle; and
- 20.3 regularly review their distribution arrangements, and make enhancements or improvements, or remedy issues, as necessary.
- 21 These obligations would be supported by the requirement in the Bill for financial institutions to design their fair conduct programme with regard to relevant factors such as the types of intermediaries that are involved in the provision of relevant services and products. The standard of conduct remains the same (i.e. institutions need to ensure their consumers are treated fairly regardless of the arrangements used to distribute products and services) but a proportionate approach can be taken to mitigate risks.
- 22 Officials will review the current requirements to ensure they give effect to these obligations, and amendments will be made in the SOP if required to give clear effect to them. I also anticipate that the FMA will issue guidance where appropriate to support these obligations.

*I propose to limit the scope of intermediaries' activities covered by the Bill to focus on sales and distribution*

- 23 In the Bill as reported back, stakeholders raised concerns about the scope of who was caught as an intermediary. This is because financial institutions would potentially have liability for overseeing the conduct of a wide range of parties over whom they would not normally have this level of oversight, and

who have limited interaction with consumers and limited impact on consumer outcomes.

- 24 Following lengthy discussions between officials and industry, I consider that it would be appropriate to limit the scope of “intermediary” to only those who are selling or distributing products or services to consumers. This means financial institutions will have responsibilities under the Bill to oversee these parties (e.g. financial advice providers such as insurance or mortgage brokers, retailers selling add-on insurance or credit) but not parties involved in broader preparatory, administrative and claims fulfilment services (e.g. lawyers, plain English writers, panel beaters in relation to motor vehicle insurance).
- 25 Both financial institutions and financial advisers have also raised the concern that the regime overlaps with or duplicates the regulation of financial advice under FSLAA. Both regimes require the consideration of consumer interests in relation to the distribution of products and services. For example, the Code of Professional Conduct under FSLAA requires a person who gives financial advice to treat clients fairly.
- 26 I have considered these views but concluded that it would not be appropriate to narrow financial institutions’ obligations in a way that excludes their distribution arrangements with intermediaries who are regulated under FSLAA. It is important that financial institutions understand (and are responsible for) whether consumers are experiencing good outcomes from their relevant services and products, regardless of the distribution channel used. The Bill enables institutions to take a proportionate, risk-based approach when considering their distribution arrangements, including taking into account whether or not their intermediaries are regulated under FSLAA (or any other regulation).

*I propose to introduce flexibility into the Bill to accommodate the unique structure of the Lloyd’s insurance market*

- 27 The Lloyd’s insurance market has a unique structure for the provision of insurance and the Bill’s requirements do not apply naturally to Lloyd’s market participants. I propose amending the Bill so that the conduct obligations apply to those participants in the Lloyd’s market who are in the best position to meet them. This approach will ensure the FMA has effective supervisory and enforcement powers and that Lloyd’s market participants are not subject to unreasonable compliance obligations.
- 28 The Bill as currently drafted applies conduct obligations to Lloyd’s underwriting members, who provide the capital that backs insurance policies issued on the Lloyd’s market. However, underwriting members do not perform most of the functions of a traditional insurer and have no responsibility for the management of consumer business. Instead UK-registered companies called “managing agents” are set up to manage syndicates of underwriting members and to manage the day-to-day operations of the syndicate, including arranging for the distribution of insurance products to consumers through third-party brokers or cover-holders.

- 29 I therefore propose that conduct obligations in the new regime will apply to Lloyd's managing agents and not to underwriting members. I further propose that the minimum requirements for managing agents' fair conduct programmes will be set out in regulations. The regulations will differ from the requirements in the Bill only to the extent necessary to ensure this is workable, given the unique structure of Lloyd's.
- 30 I also propose exempting underwriting members from the requirement to be licensed, subject to conditions. These conditions will include the obligations to be imposed on Lloyd's managing agents, and will seek to reflect (where appropriate) the conduct obligations placed on other financial institutions through the Bill and the licensing framework (e.g. require them to report certain information). In addition, I propose to enable these exemption regulations to specify the consequence of a breach of the terms and conditions, including imposing civil liability directly on managing agents and removing liability on underwriting members.
- 31 This approach will reduce unnecessary and duplicative licensing obligations for Lloyd's while still requiring the managing agents to meet obligations broadly equivalent to those placed on other financial institutions under the Bill.

*I propose to amend the Bill to ensure financial institutions need to consider the potential vulnerability of consumers*

- 32 Consumers in vulnerable circumstances may be more likely to experience harm, can be impacted disproportionately by poor conduct, and are less likely to make a complaint or advocate for themselves. The Bill as currently drafted does not specifically reference consumer vulnerability, although aspects of the Bill could be seen to require financial institutions to take consumer vulnerability into account in their fair conduct programmes.
- 33 I propose to amend the Bill to make it clear that the potential for consumers to be in vulnerable circumstances must be taken into account by financial institutions when developing their fair conduct programmes.

### **Regulations to support the new regime for the conduct of financial institutions**

- 34 Officials also sought feedback on whether regulations would be necessary to prescribe additional requirements or to support existing duties in the Bill. Having taken into account feedback from submitters, further advice from officials, and the principles-based nature of the new regime, I do not propose to make a significant number of supporting regulations at this time.
- 35 I anticipate that the FMA will work with industry before and during implementation of the new regime in order to ensure that the expectations of financial institutions are clear, including by issuing guidance where appropriate. I will consider making regulations in the future if it becomes apparent that more prescription is necessary to achieve the desired outcomes of the regime.

*I propose to prohibit sales incentives based on volume or value targets*

- 36 Persons who are involved in the sale and distribution of financial services and products may receive commissions or otherwise be incentivised. These incentives may give rise to conflicts of interests. In particular, target-based sales incentives create a strong conflict between the interests of consumers and the interests of the person eligible to receive the incentive, which increases as the person nears the target.
- 37 Cabinet has already agreed to regulate sales incentives that are based on volume or value targets [DEV-19-MIN-0237 refers]. I propose to give effect to Cabinet's decision by making regulations that expressly prohibit financial institutions and intermediaries from offering sales incentives based on volume or value targets to their frontline employees, agents and intermediaries.
- 38 I intend to exclude senior managers and executives from the scope because the greatest conflict of interest is likely to occur at the mid-to-lower levels of an organisation where individuals are more directly involved in the chain of distribution. It is uncommon for senior managers and executives to receive sales incentives based on volume or value targets (although they may receive incentives designed to grow the business, such as incentives based on increases in market share). This approach is aligned with the FMA's expectations for banks following the conduct and culture reviews, in relation to the removal of sales incentives for frontline staff and their managers. It allows for incentives to be offered as part of reasonable remuneration at the senior level where they may technically be caught by the prohibition, but are less likely to drive strong conflicts of interest at the point of sale.
- 39 It is important to note that the Bill as reported back includes a broad obligation for financial institutions to design and manage incentives to mitigate or avoid any adverse impacts on the interests of consumers. This broad obligation applies to all incentives, including those offered to senior managers and executives, and should address the risk of 'top down' sales pressure resulting in poor customer outcomes. I will consider making further regulations in future in the event that this obligation does not sufficiently address these risks.

*I propose to declare contracts of insurance as financial products under fair dealing provisions*

- 40 I propose to make regulations addressing one technical proposal made in the discussion document. This is to declare that insurance contracts are covered by the "fair dealing" provisions of the FMC Act, which prohibit misleading conduct in relation to certain products and services. The Act already provides substantive coverage of misleading conduct in relation to the service of "acting as an insurer". Expressly declaring insurance contracts (i.e. the products) to be financial products would make it clear that misleading conduct in relation to insurance contracts is prima facie a matter for the FMA under the FMC Act, rather than the Commerce Commission under the Fair Trading Act.



### Next steps

- 41 I intend to table an SOP following Cabinet approvals and drafting by the Parliamentary Counsel Office, with the intention of passing the Bill by mid-2022.
- 42 I note that there would be operational risks in delaying the passage of the Bill. Officials are working with the FMA on managing these risks.

### Financial Implications

- 43 There are no financial implications from the recommendations in this paper. However, Cabinet previously noted that implementation of the new conduct regime will have fiscal implications and will likely require additional funding for the FMA [DEV-19-MIN-0237 refers].
- 44 Cabinet also agreed in September this year to release a discussion document to consult on funding and levy options to enable the FMA to oversee the conduct regime and two other new legislative regimes [DEV-21-MIN-0196 refers]. I intend to report back to Cabinet on the outcomes of consultation on FMA funding and levies in early 2022.

### Legislative Implications

- 45 The proposals in this paper will be implemented through an SOP to the Bill and through regulations made under the Bill. I plan to seek approval for lodgement of this SOP and regulations through the Cabinet Legislation Committee (LEG).

### Impact Analysis

- 46 A Regulatory Impact Statement has been completed and is attached in **Appendix 1**.
- 47 MBIE's Regulatory Impact Analysis Review Panel has reviewed the Regulatory Impact Statement in Appendix 1. The Panel considers that the information and analysis summarised in the Impact Summary meets the criteria necessary for Ministers to make informed decisions on the proposals in this paper.
- 48 Treasury's Regulatory Impact Analysis (RIA) Team has determined that the proposal relating to making regulations to prohibit sales incentives is exempt from the requirement to provide a Regulatory Impact Statement on the grounds that relevant issues have been addressed by existing impact analysis [DEV-19-MIN-0237 and [Regulatory Impact Statement: Regulatory regime to govern the conduct of financial institutions](#)].
- 49 The RIA Team has also determined that other minor or technical amendments in this Cabinet paper are exempt from the requirements to provide a Regulatory Impact Statement on the grounds that they have only minor impact on businesses, individuals or not-for-profit entities.

## Population Implications

- 50 There are not expected to be significant implications for specific population groups as a result of the recommendations in this paper. However, consumer vulnerability is addressed in various ways in the Bill, and there are likely to be positive impacts from the introduction of the conduct regime on population groups that are more likely to be in vulnerable circumstances, for example people in financial hardship, seniors and disabled people.

## Human Rights

- 51 The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

## Consultation

- 52 The Treasury, FMA, RBNZ, Commerce Commission and Parliamentary Counsel Office have been consulted on this paper. The Department of the Prime Minister and Cabinet (Policy Advisory Group) has been informed.
- 53 MBIE has completed extensive consultation in developing the proposals set out in this paper, including the release of the two discussion documents in April and May 2021. The feedback received has been used to inform the final proposals given in this paper, as described above.

## Communications

- 54 MBIE will inform affected stakeholders of the decisions in this paper.

## Proactive Release

- 55 This paper will be published on MBIE's website within 30 business days of decisions being confirmed by Cabinet, subject to withholdings as appropriate and consistent with the Official Information Act 1982.

## Recommendations

The Minister of Commerce and Consumer Affairs recommends that the Committee:

- 1 **note** that the Financial Markets (Conduct of Institutions) Amendment Bill, which introduces a new regulatory regime regulating the conduct of financial institutions, was reported back to the House on 7 August 2020 and is awaiting completion of its second reading;
- 2 **note** that the Cabinet Economic Development Committee previously agreed to the release of two discussion documents on outstanding aspects of the new conduct regime, and that the proposals in this paper take into account feedback from this consultation [DEV-21-MIN-0063 refers];

*Supplementary order paper*

- 3 **agree** that the scope of the Bill's provisions relating to intermediaries should be limited to intermediaries involved in the sales and distribution of the financial products and services covered by the Bill;
- 4 **agree** to remove the obligations on financial institutions to train and manage or supervise their intermediaries;
- 5 **agree** that financial institutions must have and implement effective policies, processes, systems and controls regarding their distribution arrangements, including sales and distribution activities carried out by intermediaries, to ensure they comply with the fair conduct principle;
- 6 **note** that the Lloyd's insurance market has a unique structure and that the Bill's requirements do not apply naturally to Lloyd's market participants;
- 7 **agree** that the conduct obligations in the new regime will apply to Lloyd's managing agents and not to underwriting members;
- 8 **agree** that financial institutions will be required to take into account the potential for consumers to be in vulnerable circumstances when developing their conduct programmes;

*Regulations*

- 9 **agree** that financial institutions and intermediaries will be prohibited from offering sales incentives based on volume or value targets to their employees (except senior managers and executives), agents and intermediaries;
- 10 **agree** that the minimum conduct programme requirements for Lloyd's managing agents will be prescribed in regulations;
- 11 **agree** to regulations exempting Lloyd's underwriting members from the requirement to be licensed, on terms and conditions that include obligations imposed on Lloyd's managing agents;
- 12 **agree** that these exemption regulations can specify the consequences of breaching terms and conditions, including imposing civil liability directly on managing agents, and removing liability on underwriting members;
- 13 **authorise** the Minister of Commerce and Consumer Affairs to make decisions on the terms and conditions of the licensing exemption for Lloyd's underwriting members and conduct programme requirements for Lloyd's managing agents;
- 14 **agree** to declare that insurance contracts are "financial products" for the purposes of the fair dealing provisions in Part 2 of the Financial Markets Conduct Act 2013;

*Legislative implications*

- 15 **authorise** the Minister of Commerce and Consumer Affairs to issue drafting instructions to the Parliamentary Counsel Office to give effect to the above recommendations;
- 16 **authorise** the Minister of Commerce and Consumer Affairs to make additional policy decisions and minor or technical changes, consistent with the policy intent of this paper, on issues that arise during the drafting of the supplementary order paper and regulations.

Authorised for lodgement

Hon Dr David Clark

Minister of Commerce and Consumer Affairs