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Financial Markets Policy
Building, Resources and Markets
Ministry of Business, Innovation & Employment
Wellington 6140

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Submission on the Conduct of Financial Institutions Options Paper

The Institute of Directors (IoD) appreciates the opportunity to comment on the Ministry of Business, Innovation & Employment's (MBIE) [options paper](#) on regulating the conduct of financial institutions. The high-level outcome of MBIE's review is to ensure that conduct and culture in the financial sector is delivering good outcomes for all customers. This follows reviews by the FMA and RBNZ into the culture and conduct in banks and life insurers in New Zealand, and the Australian Royal Commission of Inquiry into Misconduct in the Banking, Superannuation and Financial Service Industry.

Boards are ultimately accountable for what goes on in their organisations and they have a core role in leading and overseeing corporate culture and conduct. Culture and conduct is one of the IoD's top five issues for directors in 2019 and was a key theme for our membership this year at IoD events and in our publications. The IoD supports boards focusing on long-term sustainability, ethical behaviour, good customer and shareholder outcomes, and a healthy culture for staff.

The IoD's submission mainly focuses on issues raised by the options paper affecting the scope of directors' duties and personal liability. Notwithstanding our comments here, the IoD may make further comments as the review progresses.

About the Institute of Directors

The IoD is a non-partisan voluntary membership organisation committed to driving excellence in governance. We represent a diverse membership of over 9,000 members drawn from listed issuers, large private organisations, small and medium enterprises, state sector organisations, not-for-profits and charities.

The IoD's *Code of Practice for Directors* provides guidance to directors to assist them in carrying out their duties and responsibilities with high professional standards. All IoD members sign up to the Code.

Our Chartered Membership pathway aims to raise the bar for director professionalism in New Zealand, including through continuing professional development to support good corporate governance.

Overview of options

MBIE has set out in the options paper its preferred package of options to address problems that have been identified. This includes:

- new duties for financial institutions (banks and insurers and possibly other similar organisations such as KiwiSaver providers, Non-Bank Deposit Takers, and lenders)
- personal liability for directors and senior management
- measures to address conflicted remuneration and incentives
- obligations regarding insurance claims handling
- measures to ensure financial products are suitable for customers and

- greater powers for the FMA to monitor and enforce compliance.

Proposed duties and personal liability

MBIE recommends the following overarching duties that would apply to all aspects of a financial institution's activities in their dealings with retail customers:

- 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.

If an entity breaches a duty, MBIE has proposed that directors and senior managers could be personally liable. MBIE is proposing to bring in an 'executive accountability' regime which commonly have the following elements:

- a requirement that senior management be capable and competent
- clear lines of accountability for monitoring conduct (eg a particular individual is accountable for ensuring the organisation complies with certain duties)
- individual penalties for failures to meet accountability standards
- rules of conduct for senior executives.

It appears that this is intended to also include directors.

IoD comments

We support MBIE reviewing options for improving culture and conduct in financial institutions in New Zealand, including addressing any significant regulatory gaps.

We highlight that New Zealand is ranked first by the World Economic Forum's *Global Competitiveness Report 2017/18* for the ethical behaviour of its private institutions and for the efficacy of its corporate boards. The 2019 FM Global Resilience Index also ranks New Zealand second out of 130 countries for corporate governance. New Zealand's financial services sector is also generally considered to be well regulated.

Australia's regulatory regime is identified by the options paper as being more "intensive" than New Zealand's (and, by implication, in some way more effective). At least since the collapse of HIH Insurance in 2001, Australia has steadily increased the powers of its regulators and the nature and extent of liability imposed upon management and directors. The Australian Royal Commission's findings confirm that this approach has not delivered the desired outcomes.

It is also important to note that the FMA and RBNZ reviews into culture and conduct in banks and life insurers in New Zealand didn't find the same level of systemic issues that were present in Australia. Organisations subject to the above reviews are currently involved in responding to issues. The options paper notes that societal expectations of financial institutions are changing and we expect boards will adapt to meet this change given the opportunity.

To the extent that regulatory reform is warranted, it must be proportionate and augment the existing legal framework. MBIE should also be cautious in adopting solutions of other jurisdictions in the absence of clear evidence that they are effective and appropriate for our regime.

Proposed duties

The proposed duties are in effect new director duties imposing greater obligations. Any new duties should be carefully considered and imposed only to the extent necessary. The options paper outlines pros and cons of the duties including significant costs, uncertainty and questions around whether they can be enforced. There are also issues with how the proposed duties fit with the current legal framework, for instance:

- the proposed duties duplicate those already in place (eg the duty to exercise the care, diligence and skill expected of a reasonable director under the Companies Act 1993)
- it is unclear how the proposed duties focused on customer interests relate to the duties under the Companies Act with reference to stakeholder interests
- it is unclear how the proposed duties fit with existing protections under consumer legislation and what are reasonable and workable obligations and protections for financial institutions and customers respectively. These issues are significant and need to be addressed.

We note Peter Watts QC's article *To Whom Should Directors Owe Legal Duties in Exercising their Discretions? – a Response to Mr Rob Everett*.¹ This highlights relevant issues including essentially how new duties may “make directors potentially less accountable rather than more accountable”, and “the inappropriateness of meddling with the content of a director’s fiduciary duty”.

We are concerned that the proposed duties may also merge the role of the board and management, undermining the essence of corporate governance in New Zealand. As noted in the Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (2019) “Boards cannot, and must not, involve themselves in the day-to-day management of the corporation ... The task of the board is overall superintendence of the company, not its day-to-day management.” A core role of boards is to hold management to account through effective and independent oversight of performance and compliance matters. It is critical that this separation is maintained under any new regime.

As an alternative, the combination of increased self-regulation with external oversight would provide an opportunity for the institutions concerned to adapt to the societal expectations identified, and this should be given more consideration.

The IoD strongly opposes the introduction of director personal liability where an entity breaches a duty as this is a disproportionate response to the issues identified. This proposal has the potential to seriously undermine the overall strength of corporate governance in New Zealand and we highlight our key concerns with this proposal below.

Deterring directors from serving on boards

Directors can be exposed to significant liability in their positions and this has been increasing over time across legislative and regulatory regimes (eg in relation to health and safety). The criminalisation of cartels is another example from this year and there are other proposals to introduce director personal liability (including under the Credit Contracts and Consumer Finance Act and tax legislation). These changes have a cumulative impact on directors and organisations.

Given this, there is a real likelihood that increased personal liability could be a significant deterrent for directors and potential directors from seeking board roles in financial institutions. This risk is particularly high for directors of financial institutions, when compared with directors of other entities in other sectors. Directors have the choice to contribute to New Zealand in a range of ways, and we are already aware that many favour serving on boards of private companies that are not operating in the financial services industry because of the lower risk profile.

¹ Peter Watts QC, Editorial for the Company and Securities Law Bulletin May 2019 (LexisNexis, Wellington, New Zealand).

It is critical that boards (especially our largest financial institutions) attract well qualified, experienced directors to help raise the standard of governance in organisations, and trust and confidence in business and capital markets in New Zealand. We are very concerned that the imposition of new duties, underpinned by personal liability, will limit this.

We encourage MBIE to take a system-wide view of board and director responsibility and personal liability in their cost/benefit analysis.

We also highlight that being a director can carry a high level of reputational risk along with responsibility. There are a number of examples in New Zealand and Australia in the last 12 months where directors have faced significant public scrutiny when things have gone wrong in their organisations. Personal reputation is front of mind for directors and a strong driver for them in ensuring organisations are well governed. We question how introducing further personal liability will make directors focus even more on ensuring their organisations are well governed.

Compliance and risk averse boards

Boards have a fundamental role in setting, driving and overseeing strategy. They must be continually engaged in strategic matters to ensure the long-term sustainability of their organisations. This is particularly important in today's complex and challenging operating environment for many organisations. They also have a responsibility to set risk appetite and oversee and monitor risk management.

The impact of increased director liability adds to boards' growing regulatory burden and means they can spend disproportionately more time on compliance rather than performance. Our 2018 Director Sentiment Survey found that 71% of directors were spending more time on compliance related activities in the last 12 months. This is related in part to receiving more information on financial and non-financial risks (including on culture and conduct, health and safety, digital, cybersecurity and climate issues). Financial institutions already have a significant regulatory workload and there is a real risk that they could be overburdened with compliance if reform is not proportionate and appropriate.

We are also very concerned that the proposed change will lead to boards becoming more risk adverse (ie not taking appropriate business risks). This could ultimately impact business success, and stakeholders.

Cost burden on institutions and insurance

The options paper notes further regulation will increase compliance costs for business. The greater the regulation, the greater the increase in such costs for organisations, directors and customers.

The proposed duties and personal liability will also affect the cost of Directors and Officers insurance (D&O). The cost of D&O insurance has already risen significantly in recent years and is prohibitive for some organisations. The Australian Law Commission noted increases of more than 200 percent in the 12 to 18 months to June 2018,² and we are aware that the percentage is considerably higher for some organisations. There are a number of factors that have contributed to the turbulent D&O insurance market including:

- the board's role and responsibilities have expanded in recent years
- policy-makers continue to target directors for personal liability in reforming regimes
- regulators are more active and well-funded
- class actions are on the rise
- there have been substantial court awards against directors and organisations

² Australian Law Commission Reform, *Inquiry into Class Action Proceedings and Third-Party Litigation Funders* (June 2018).

- litigation funding is prevalent, and there are activist law firms (appearing and organising their own claims) and liquidators pursuing directors with sizeable D&O policies / personal assets.

The dramatic rise in D&O costs is very concerning and the impact of the addition of new duties and personal liability could be severe.

Conclusion

We support MBIE reviewing options for improving culture and conduct in financial institutions in New Zealand, including addressing any significant regulatory gaps. However, any regulatory reform needs to be proportionate and augment the existing legal framework. MBIE should also be cautious in adopting solutions from other jurisdictions in the absence of clear evidence that they are effective and appropriate for our regime.

We are concerned about the scope of the proposed duties. These need to be carefully considered and imposed only to the extent necessary. The IoD strongly opposes the introduction of director personal liability where an entity breaches a duty as this is a disproportionate response to the issues identified. This proposal has the potential to seriously undermine the overall strength of corporate governance in New Zealand and may have adverse effects and unintended consequences, including deterring qualified and experienced directors from serving on boards of financial institutions.

We appreciate the opportunity to comment on behalf of our members and would be happy to discuss this submission with you.

Yours sincerely



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