

## Submission on the Financial Institutions Conduct Review Options Paper

7 June 2019

### Introduction

1. This is a submission on behalf of the **20 Licensed Managed Investment Scheme Managers** listed in the **Appendix**.
2. We are grateful for the opportunity to comment on the Conduct of Financial Institutions Options Paper ("Options Paper").
3. Our comments are limited to the question about whether the options proposed for banks and insurers should be extended to independent MIS Managers/KiwiSaver providers and other FMC Act licensed entities that are already subject to significant conduct oversight.
4. In summary:
  - a. We support regulatory frameworks that overall lead to good outcomes for consumers; However
  - b. For organisations that are already significantly regulated from a conduct perspective, it would be preferable to address any concerns (if and when they arise) within the existing FMC Act licence framework, rather than overlaying a further layer of regulation. An additional layer of regulation will create uncertainty as to what is expected and whether current licence obligations are altered or not; and
  - c. The conduct obligations proposed in the Options Paper may not be fit for purpose for our sector (the MIS sector) or for other licensed FMC Act entities that are not part of a bank or insurer. This is because the proposed obligations are derived from a review of institutions that have very different characteristics from FMC Act licensed entities. The different characteristics (e.g. staff numbers, complexity of business, existing regulatory framework and nature of products offered) create different kinds of conduct risk to solve for.
5. We note that all the major banks and the large insurers hold MIS licences. However, the effect of this is that only a small part of their business is regulated from a conduct perspective, rather than the business as a whole. Also the more contentious mass market products that banks and insurers provide are essentially unregulated (the Options Paper gives the examples of credit insurance and funeral cover). Therefore for the purposes of our comments we are treating the banks and insurers as unregulated from a conduct perspective, as per the Options Paper. A major point of difference between businesses like ours and prudentially regulated businesses is the fact that conduct regulation already captures our whole business and therefore also permeates our business culture.

How banks and insurers have different characteristics to typical MIS managers and how those differences drive different kind of conduct risk

6. The table below illustrates the differences between typical MIS Managers/KiwiSaver providers and banks/insurers that drive fundamental differences in terms of how conduct and culture risks play out. (It is worth noting that the Australian Royal Commission also tended to focus on entities of an exponentially different scale to the majority of the NZ MIS sector.):

| Characteristic                             | MIS Manager   | Insurer or bank   | Impact on culture and conduct   |
|--|---|---|---|
| Complexity of business and number of staff | MIS Managers (excluding banks and insurers) tend to employ between 10-50 staff and would operate 1-2 offices. | Large prudentially regulated institutions employ hundreds or thousands of staff, may have branches throughout New Zealand, and will likely operate a complex corporate structure. | <p>In large complex organisations there is potentially a significant distance between front line and senior management. This raises questions about whether senior management appreciate pressures front line staff are under and/or really understand how they behave toward end customers.</p> <p>In a typical MIS Manager, the CEO, all senior staff and all front line staff are likely to sit together on the same floor and interact with each other continuously.</p> <p>In large complex businesses there is increased probability of silos or pockets of a business operating in accordance with their own poor cultures, or groups of staff whose remuneration causes them to act in unexpected ways.</p> <p>Therefore issues around broader business culture and governance are far more challenging in the larger organisations.</p> <p>Scale also means that the relative burdens of regulation are lower, while the public benefit arising from regulation is potentially greater due to greater customer numbers receiving the benefits.</p> |

|   |  |   |  |
|---|--|---|--|
|   |  |   | For new entrants the proportionately greater costs of regulation than large prudentially regulated players face is a potential barrier to entry.   |
| Opportunity for cross selling (which raises miss-selling concerns)  | MIS Managers tend to sell MIS products only and they tend to be focused on their target segments.  | Banks and large insurers sell a broad suite of products and would frequently have the opportunity to offer a customer who came in for one product a second product.<br><br>For example a customer seeking a homeloan might naturally be asked if he or she wishes to update his or her insurance policies.  | In the larger businesses there is greater danger of customers being sold bolt on or additional products that may not be suitable.<br><br>The recent overseas unsuitable product scandals have involved major banks selling an inappropriate bolt on product following the sale of an otherwise suitable product. The Options Paper notes the example from the UK of banks selling inappropriate credit card insurance as a bolt on to the selling of credit card accounts. |
| Nature of products sold, the regulatory process those products have to be put through prior to launch, and ongoing regulatory oversight of those products | MIS funds are relatively homogenous in terms of their features.<br><br>The FMC Act disclosure regime provides a prospective investor with a means of evaluating product suitability and risk in the form of a short prescribed PDS document. The Risk Indicator is particularly intended to provide an indication of suitability.<br><br>To date all FMC Act regulated offers are risk assessed, all high risk offers are reviewed by the FMA, and where the FMA has reviewed regulated offers and found issues of material concern, disclosure and offer information are improved or withdrawn (See for example FMA Statement | Banks and insurers have been free to create offers of exotic products that are not subject to prescribed offer documents and that have never been subject to regulatory review because they fall outside of the FMC Act regime, such as credit insurance. These are the products that have raised product suitability concerns.<br><br>There is no ongoing reporting of these products.<br><br>There is often very little, if any, public discussion or comparison of insurance products and this is difficult to do because the exclusions can differ so greatly.<br><br>Also the exotic banking products that have raised concerns do not get | The case for product design obligations is much greater in the case of banks and insurers than for MIS.  |

|  |   |  |  |
|--|---|--|--|
|  | <p>of Performance Expectations 2016-2017 items 2.4-2.6)</p> <p>Given the likelihood of our offers being subject to assessment and review by the FMA in the event that our offer is non vanilla, we believe that the suitability of MIS products can naturally be identified and addressed during pre registration review of the PDS by the FMA, or during risk assessment if it has not been put through pre registration review, or during discussion of the “reasonableness” of fees in the case of KiwiSaver.</p> <p>Even prior to the FMA’s opportunity for review, the Supervisor will first review the documents with a view to protecting the end customer.</p> <p>Further, regulated offers are subject to a two-pronged ongoing regulatory oversight approach, with the Supervisor reviewing ongoing reporting information and the FMA monitoring at a more macro level e.g. by way of the KwiSaver tracker.</p> <p>All regulated offers are compared like for like on the Smart Investor website. In addition to Smart Investor, there are other sources of independent comparison of schemes, including the Sorted website and industry investment research providers.</p> <p>Given public interest in KiwiSaver, providers that are mis-selling or selling poor products will be publically</p> | <p>compared with each other in mainstream media.</p> |  |
|--|---|--|--|

PROSPECTIVELY RELEASED

|                   |  |  |  |
|-------------------|--|--|--|
|                   | <p>called out in the media and by competitors. For example, any given week media such as the Herald will be publishing opinions of KiwiSaver providers giving views on other KiwiSaver providers.</p>  |  |  |
| Regulator mandate | <p>One regulator, one set of conduct obligations that wrap around the business in a comprehensive way via the licensing process and ongoing monitoring.</p> <p>There is also a further more granular layer of oversight from the Supervisor.</p>   | <p>Three regulators, none of which have to date had a clear mandate or resource to regulate the business in totality from a conduct perspective.</p> <p>Regulatory obligations in a patchwork quilt of sources but no comprehensive conduct regime.</p>  | <p>With entities that are already licensed (and have their whole business examined) from a conduct perspective, a new and layer of obligations is more likely to create uncertainty than be helpful or identify issues.</p> <p>This is because it may be unclear whether the new high level rules change anything in terms of existing processes under more granular obligations.</p> <p>For banks and insurers the rationale for creating something new to cover the obvious gaps in the regime is much stronger. (Whether the proposals are correct for banks and insurers is not for us to comment on.)</p> |
| Distribution      | <p>Depending on the business model, MIS managers may or may not have control over the sales process or even visibility as to who the end customer is. For example, if funds are listed or a customer comes via a wrap platform there is little if any visibility or control as to who the acquirer is.</p> <p>There are also unaligned financial advisers who may recommend products. MIS managers may have little control over the sales processes of those advisers. (Indeed if the adviser is truly independent, the MIS Manager should have no control over the recommendation.)</p> | <p>Banks and many insurers have direct control over the sales process, at least through some distribution channels.</p> <p>Banks will sell some listed products that may have the same issues. Insurers that rely on unaligned financial advisers to distribute their products can face similar issues to MIS managers.</p> <p>The products that appear to have raised concerns about product design in other jurisdiction e.g. homeloans with embedded derivatives or credit insurance appear to have been sold directly.</p> | <p>This raises questions as to whether it is practically possible to monitor and collect information as to who is acquiring products and how the sales process works in all instances.</p> <p>We note that if customer tracking/distribution obligations are imposed, then this is another example of regulation that favours the large players. The ability to track post product design favours large entities with their own distribution networks or closely bound advisers that they have direct control over, or larger entities (such as banks and insurers) with greater resources to track</p>        |

|   |   |   |  |
|---|---|---|--|
|   |   |   | <p>and monitor unaligned financial advisers.</p> <p>For MIS managers the best opportunity for addressing any suitability concerns is ex ante via preregistration processes, rather than ex post via tracking.</p>  |
| <p>FSAP 2016</p> <p>(In 2016 the IMF carried out an in depth assessment of NZ's financial stability. This included a review of the banking system, the insurance sector and securities regulation with a particular focus on MIS)</p> | <p>The FMA's paper " IMF 2016 review of New Zealand" states on page 8 in relation to the assessment of the MIS sector:</p> <p>"The overall regulatory framework for asset management is well developed, but would benefit from some enhancements to prevent the build-up of risks. The regulatory perimeter could be reviewed to include wholesale asset managers and custodians, whose activities will become more relevant as the asset management industry matures, bringing potential new risks."</p> | <p>In relation to insurance, the FMA's paper " IMF 2016 review of New Zealand" states on pages 8 and 9 in relation to the assessment of the MIS sector:</p> <p>"There is a need for more focus on the regulation of insurance intermediaries and insurance conduct, which is likely to require increased resources. The government and the FMA have been moving in this direction under recent legislation and in the FMA's supervisory initiatives, including on high life insurance commissions.</p> <p>...</p> <p>There is a need to extend the range of conduct of business requirements specific to insurance beyond the current focus on advice, and to ensure that the appropriate requirements apply to all insurance activity, including sales without advice and ancillary sales."</p> <p>While the banking system was found to be generally resilient, the IMF considered that there was a need to adopt a "more intensive approach to supervision" (see New Zealand Financial Stability Assessment 10 April 2017)</p> | <p>For banking and insurance sectors, the IMF gave a clear steer that it had concerns about the lack of supervisory oversight. It also identified conduct gaps to fill. (See para 32 of the Options Paper which also records this point.)</p> <p>For the securities sector, particularly focusing on MIS, there was an endorsement that the regime appeared appropriate and was developing in the right direction. (At that point the FMC Act regime was relatively new so that findings in respect of this sector were not conclusive or binding.) (It is worth noting that the Options Paper refers to IMF reporting on banks and insurers at para 32 but omits to acknowledge findings in relation to the MIS sector.)</p> <p>Therefore objective third party review of the regulatory frameworks in place, appears to support further regulation of banks and insurers to cover gaps and supervision deficiencies but not a need to extend that additional regulation to MIS managers.</p> |

Any culture concerns with MIS Managers are more effectively addressed via existing frameworks

7. There are multiple opportunities to identify any conduct or culture issues (or product suitability issues) that arise in MIS/KiwiSaver businesses, that have not been the case in respect of banks and insurer businesses at large:
  - a. We go through a licensing process that captures our full business, which can explore governance systems and the culture of an organisation in significant detail;
  - b. We are subject to regular visits from Supervisors in respect of our core business;
  - c. We may receive FMA monitoring visits or EBRM visits from time to time;
  - d. Our products tend to be vanilla in nature and subject to standard prescribed disclosure, such that non vanilla offers that may raise suitability issues are easy to identify upfront;
  - e. When we offer a product:
    - i. Our Supervisors will review the offer in the first instance with the end customer in mind; and
    - ii. We will very likely engage with the FMA in respect of an offer before lodgement (unless it is essentially a repeat of an existing offer) because if we do not the offer will be risk assessed by them in any event, and they would likely initiate engagement at a less opportune point in the process if there are any features of the offer that they consider raises concerns; and
    - iii. In the case of KiwiSaver products, discussions around the reasonableness of fees will be a further opportunity to tease out whether there are any unusual features in an offer; and
  - f. We provide ongoing reporting which provides further opportunity for Supervisor and regulator review.
8. Ultimately for us, the need to have constructive ongoing relationships with the FMA and our Supervisors would generally create incentives to address conduct concerns, even if there is no specific breach of regulations.

Conclusion

9. Our group of businesses is open to having our obligations refined within our existing framework, so as to continuously improve our approach for the end customer. We also consider that there will always be topics where further guidance would be helpful from the regulator or MBIE. For example, those of us that offer KiwiSaver are eagerly awaiting MBIE's formula for how projections for retirement should be calculated, so that the industry can all be on the same page. In essence, changes that are targeted, meaningful for our business, clear to us in terms of what they entail, and consistent with our licence are helpful and likely to result in better outcomes for customers.
10. What we disagree with is having a second layer of obligations imposed on top of our existing obligations, which may or may not require changes to current practices, which may or may not be relevant to our business model, and which are unclear in terms of what is expected because they are high level and open to considerable interpretation. This is simply more regulation, not better regulation.



**Appendix – Licensed MIS Managers supporting this submission**

- Amanah Trust Management (NZ) Limited and AmanahNZ KiwiSaver Limited
- Augusta Funds Management Limited
- Clarity Funds Management Limited
- Conrad Funds Management Limited
- Devon Funds Management Limited
- Generate Investment Management Limited
- Harbour Asset Management Limited and First NZ Capital Securities Limited
- Milford Funds Limited
- Mint Asset Management Limited
- New Zealand Assets Management Limited
- Nikko Asset Management New Zealand Limited
- Norfolk Mortgage Management Limited
- Oyster Management Limited
- Pie Funds Management Limited
- QuayStreet Asset Management Limited
- Salt Funds Management
- Senior Trust Management Limited
- Silverfin Capital Limited
- Simplicity NZ Limited
- Whai Rara Fund Limited