2021 Review of the Financial Markets Authority Funding and Levy

7 November 2021

Introduction

1. This is submission is by the **Boutique Investment Group (B.I.G**.) on behalf of the Managed Investment Scheme Managers listed in **Appendix 1**. No part of this submission is confidential. Please contact Simon Haines, B.I.G. Chair at Privacy of natural persons for any queries.

2. In summary:

   - In terms of resourcing: the Climate Related Disclosure regime (CRD) will be new territory, not just for New Zealand, but for the world generally. Accordingly, it is important that the FMA (and other relevant public sector entities) receives sufficient funding to provide education, guidance and leadership to the market. Therefore, we support Option 1 for funding resource.

   - In terms of who should meet the costs of resourcing the FMA: A principle that has always run through funding decisions in relation to the FMA is that the Crown should fund public benefits of the regime and the private sector should fund private benefits. Applying that logic, the Crown should meet the full costs of regulating the CRD, as the regime is primarily for the public benefit, and industry should meet its own significant costs in giving effect to the CRD:

     - We note that the CRD was introduced as part of a package of reforms to assist New Zealand to transition to a low carbon economy and also to improve its standing globally by showing leadership in the arena of climate change. Therefore there is a particularly high public benefit to this regime and the public sector costs proposed are relatively modest.

     - We acknowledge that we have a role to play in facilitating the transition to a more sustainable future. Even if the Crown pays for the public sector costs of the CRD, our contribution (or those of our customers) would be the very significant additional costs that we will be exposed to in order to produce the reporting required by CRD. More specifically, we will need to build up our own internal capability to monitor and report, we need access to data and we will need to pay for assurance (once that obligation kicks in).

Therefore to the extent that there are private benefits from the regime, these will very rapidly be absorbed in the additional costs we face, long before FMA levy costs are taken into account.

- Looking at funding issues and regulatory costs in our sector more broadly, the funding proposals represent a further turn of the screw in relation to a number of ongoing problems:

    - Government and the FMA are continuing to drive regulatory costs into our sector on one hand, while continuing to place pressure on us to reduce fees on the other. This squeeze on both sides cannot happen indefinitely without consequence;

    - We have previously noted the lack of equality in regulatory costs as between different categories of entity. For example, DIMS providers compete in the same markets as MIS managers for the same clients (much of the time) and the fundamental skill of both types of entity is to invest money. However, we are exposed to totally different regulatory costs. DIMS already face lower general FMA levies and no supervisor costs. DIMS are also not subject to reporting under CRD, so this will further exacerbate the inequality. At some point, MIS managers may be forced to restructure as DIMS providers if the trend continues. (Our point is not to attack DIMS providers but to point out that far more effort goes into FMA's pitch for money than into the question of how the burdens should be distributed and this is causing distortions in our market); and

    - Linked to the point above, we have previously raised concerns that we are paying to be regulated twice; once by the FMA and once by our supervisors and that the levies do not take any account of the work FMA does not have to do because we are already paying for a supervisor. The FMA stated in writing that MBIE would reach out to discuss these issues, and this has not occurred. It seems a little unjust that MBIE are seeking further funding from this sector, after they have not engaged on concerns raised in respect of the previous funding round.

- We are not directly impacted by the COFI regime, so we do not have significant comments to make in respect of COFI funding. However, it does seem difficult to justify selecting the expensive Option 1 for a regime that will not come into full effect for six years, given that many of the activities pertaining to that regime such as enforcement will not be occurring in the interim.

Why the Crown should fund the CRD Regime

Principles of FMA funding

3. The FMA is funded through a combination of Crown funding and a levy charged to market participants. Each time the FMA and MBIE have consulted on making amendments to fees or levies it has reiterated the point that the Crown should fund public good elements of the regime and the private sector should fund private benefits of the regime. This is true of the current combined FMA and MBIE discussion document "2021 Review of the Financial Markets Authority Funding and Levy", dated 5 October 2021 (Discussion Document). The Discussion Document states when considering who should pay for the COFI regime and for CRD:

Criteria for assessing recovery options

205. It is intended that the following criteria will be used to assess which funding recovery option should be recommended:

- proportionality – the proportion of Crown and third-party levy funding reflects the public good element of the FMA's operations as well as the private benefit levy payers receive from well-regulated financial markets
- equity – the relative impacts of the proportion of Crown and third-party funding (e.g. ability to pay) are taken into account
- sustainability – the split of funding is sustainable and viable in the long-term and the Crown operating balance and market activity are not negatively impacted as a result of the levy.

4. In our view, for reasons discussed further below, the introduction of CRD is a rare example of regulation that has been inserted into the FMC Act for the overriding purpose of achieving a public good outcome that stands apart from most of the other additions to the FMC Act that have been primarily introduced to benefit participants and consumers.

5. Whilst the FMA may be a convenient home for fulfilling the government's role of providing guidance, education, monitoring and enforcing the new regime, this role could also have been carried out by the Ministry for the Environment or MBIE (as expressly acknowledged in the Discussion document "Climate-related financial disclosure – understanding your business risks and opportunities related to climate change). In that scenario, it seems likely that costs would have been borne more broadly. After selecting the FMA to perform this role, there seems little justification to simply apply the same methodology as to the apportionment of public versus industry funding contributions.

6. To the extent that there are private benefits arising from the CRD regime, the level of costs and risks imposed onto the sector for the purposes of building our own capability (discussed further below) reflect a fair contribution to achieving the policy goal that primarily benefits the public good.

7. This is a rare instance where, as a matter of principle the Crown should meet the full costs of adequately resourcing the FMA to fulfil its function within the CRD regime. We also note that the public sector costs of CRD are fairly modest, ranging from $1.4m $-1.8m. Thhis again points to the reasonableness of the Crown meeting these costs.

<u>Policy intent behind introducing the CRD is to facilitate transition to a low emission economy</u>

8. Government's policy intent behind introducing the CRD could not be clearer, it is to facilitate New Zealand's transition to a low emission economy and contribute to New Zealand's Paris Accord commitment of limiting global warming to a 1.5 degree scenario. This is a national, if not global goal, for the public benefit.

9. To the extent that there is discussion of repricing risks in markets in the context of the CRD, it is clear that the reason why Government is interested in this topic is because it believes that a repricing will assist with the transition to a low emission economy and limiting global warming. All roads of discussion about the CRD regime tree back to helping Government achieve its low emission and global warming goals.

10. As an example, Hansard records Hon Dr David Clark's introduction of the CRD at the first reading of the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Bill (the Bill) on 15 April 2021:

> *"…Climate change provides the overall context for the bill that we have before us today. On 2 December 2020, the Government declared a climate emergency, committing New Zealand to urgent action on reducing emissions. By declaring a climate emergency, we joined the over 1,800 jurisdictions in 32 countries to do the same and to commit to reducing emissions to avoid a more than 1.5 degree Celsius rise in global warming.*
>
> *There are a number of actions the Government has taken in response to that climate emergency, not least amongst them is the setting up of an independent climate commission which will set carbon budgets—we have one in draft, currently. We've done things like biofuels sales blend mandating, we have committed money to enable councils to decarbonise the public transport fleet by 2035, we've nominated clean-car import standards, and so on and so forth. But this bill today, I am convinced, will be one of the most important things we do in this Parliament.*
>
> *….*
>
> *The main aim is to move to a position where the effects of climate change become routinely considered as a part of business investment decisions. It'll contribute towards that goal we've set of becoming carbon-neutral by 2050. Effectively, it does this by requiring around 200 of the largest and most important businesses participating in the New Zealand financial markets to disclose clear, comparable, and*

consistent information about the risks and opportunities presented by climate change, some of the stuff I've spoken to already: where the assets present risks, where they're likely to have a future that's less certain, and so on. That current lack of reliable information about the impact of climate change on business is serious, because it can lead to mispricing in the markets, the mispricing of assets, and the misallocation of capital, and that means that investors, lenders, and other decision makers cannot then make the right decisions. There is risk of corrections in the market which can be abrupt.

We know that climate change doesn't just present risk; it also presents opportunities. That information, where it's clearly presented, shows where people can invest wisely in the future. Trillions of dollars will need to be invested globally by 2050 to achieve the Paris Agreement goal of keeping the increase in global temperatures to within 2 degrees Celsius of pre-industrial levels and to pursue efforts to limit the increase to 1.5 degrees…."

11. As another example, the Bill as reported from the Economic Development, Science and Innovation Committee provides the following commentary on what the Government is seeking to achieve:

"*…In 2018, the Intergovernmental Panel on Climate Change noted that human activities have already caused global warming of 1°C above pre-industrial conditions, and are on track to cause at least 1.5°C of warming between 2030 and 2052.*

The bill is based on the idea that financial markets will help contribute to the economic transformation that is needed to shift investment away from emission-intensive activities, towards those that are more resilient and produce lower emissions. One way of helping to achieve this is by requiring large entities to disclose information about climate-related risks and opportunities to potential investors.

The specific purposes of the bill are:

- *to ensure that the effects of climate change are routinely considered in business, investment, lending, and insurance underwriting decisions*
- *to help reporting entities better demonstrate responsibility and foresight in their consideration of climate issues*
- *to lead to smarter, more efficient allocation of capital, and help smooth the transition to a more sustainable, low-emissions economy"*

12. Overall, it is clear that CRD is just one of a number of measures being introduced to achieve a broad public good policy objective of Government that all of the economy, if not the world, will benefit from. As such, CRD stands apart from almost every other aspect of the FMC Act.

Challenges that climate reporting entities face

13. Generally an objective of regulation is to ensure that all classes of business within a relevant sector adopt minimal practices that a good operator would choose to adopt voluntarily if it had the attitude of wanting to put its customers interests first.

14. Accordingly, regulation tends to involve creating new processes, oversight and record keeping in relation to activities that we have at least some experience of carrying out.

15. In contrast, under the CRD, businesses will be required to develop entirely new capabilities and functions internally. In addition, they will have to negotiate access to relevant data, and engage relevant assurance experts. Both categories of external party present significant risks to the MIS sector because:

    a. There are a very small number of global data providers, so there is risk of our sector being held to ransom; and

    b. The assurance industry for climate reporting essentially does not yet exist in New Zealand, at least not to the extent that it will be needed.

16. Therefore to the extent that MIS managers owe a duty to assist with a transition to a low carbon economy, and to the extent that this sector may benefit from a new kind of mandatory reporting, the sector's contribution to that end is more than fairly met by all the additional, risk, complexity and cost that the CDR will bring to us.

17. We note that the Discussion Document at this point does not at all take into account the fact that significant additional costs are being imposed on the sector to give effect to a wider public sector good.

The need for FMA to be funded to provide industry leadership for CRD

18. As noted above, the MIS industry will be required to ramp up its expertise from a starting point of almost zero capability for some participants, to producing its first reports as of next year on a topic that is highly complex and specialised.

19. In addition, the climate reporting that MIS managers will be required to undertake goes beyond what TCFD reporting normally requires for fund managers. In particular, at an international level reporting by fund managers occurs at an aggregate level across all funds generally, whereas in New Zealand we will be reporting on a fund by fund basis. Therefore it is not possible to just lift and drop in something that is being done overseas.

20. Further for the CRD regime to deliver reports that will be useful to the market, there are some issues that will require the industry and regulators to work together to solve:

    a. Deciding some commonly agreed methodologies and sources of data, so that participants do not report on such a different basis to each other that any comparison between providers is effectively impossible;

b. If the intent is to describe risk within a fund, we will need to find a way to avoid the homogenising effects of aggregating data within a fund. For example, if a fund invested purely and equally in vineyards (which are heavily exposed to changes in weather but have a low emissions profile) and oil producers (that are not exposed to weather but are high emitters), the net effect may be a fund that looks relatively vanilla in terms of its emissions profile, even though everything within the fund is risky in some way;

c. How to deal with huge gaps in data and difficulty with reporting on fixed income. Particularly significant is Governments ruling themselves out of inclusion, with the consequence that any fund has its apparent exposure reduced if it contains a decent chunk of Government bonds.

21. Against the backdrop described above, the market clearly needs significant front end, support, education and guidance from public sector agencies, and the FMA clearly needs resourcing to do this.

Broader strategic issues

The issues created by driving up regulatory costs at the same time as putting downward pressure on prices

22. Individual members of B.I.G. have over the past two years had a significant amount of correspondence with both MBIE and the FMA on the topic of fees in response to; MBIE placing a huge focus on fees in its KiwiSaver default provider decisions, and FMA in relation to its work on "value for Money".

23. A particular concern from our group has been that an over emphasis on fees will ultimately lead to a market favouring a small number of low cost, vanilla scale players, that will squeeze out most other participants. We believe in the long run the market will benefit more from disruptors innovating new kinds of products.

24. It is particularly unfortunate that at the same time that both MBIE and FMA are trying to drive every basis point they can off fees; they are ramping up their own costs and are continuing to drive further regulatory costs onto the sector through additional complex rules and processes requiring significant additional resourcing.

25. In the case of the CRD regime, the proposed public sector costs of regulation in fact seem relatively reasonable. However, as noted above our new internal costs and the costs from external providers that we shall have to engage are likely to be significant.

26. It is simply not possible for pressure to be placed on both sides indefinitely without something breaking.

27. Going a step further, and looking beyond that of MIS managers and regulators, to the broader relationship between Government and businesses within New Zealand as a whole: Government appears to have an attitude that every time there is a problem, business can just keep on absorbing more costs, more complexity, and more time spent on administrative and regulatory issues rather than our core business. For the scale of our markets, New Zealand businesses (including ours), carry a disproportionate burden, relative to larger markets. This could be a contributor to New Zealand having relatively low productivity scores as against other OECD countries, despite its people working relatively hard.

MBIE has not yet fulfilled promises made to B.I.G. in relation to the previous funding round

28. B.I.G. has previously raised with FMA and MBIE the fact that we are paying for two different kinds of oversight body to operate in the same space (the FMA and our respective supervisors). We are not convinced that the combined costs are as efficient and/or effective as they could be currently. We also noted that this co regulatory model is an outlier internationally, and that we are obliged to compete both internationally and domestically with businesses that do not face the same double costs as us.

29. These issues were raised in June 2020 and FMA responded by stating that "*the structure of regulation in New Zealand are ones in which the decision-maker is not the FMA, but the Ministry of Business, Innovation and Employment and the broader Government of the day*" , but that "*FMA has engaged with MBIE on your letter, and they agree that the concerns you raise around the Supervisor system sit with MBIE, as steward of the regulatory system, rather than the FMA. MBIE will be reaching out to you to discuss the best way to further understand your concerns*". (The correspondence between B.I.G and FMA are attached as **Appendix 2.)**

30. It seems unjust that MBIE and FMA are seeking engagement and consultation on further funding, when they have not made good on promises to engage with us in respect of previous funding decisions.

Observations on funding for the COFI regime

31. We are not directly impacted by the COFI regime, so we do not have significant comments to make. We simply note that the regime is not intended to come into full effect for several years. Therefore we query whether FMA needs full resourcing for a period.

Appendix 1 – Entities supporting this submission

- Nikko Asset Management New Zealand Limited
- Alvarium Wealth (NZ) Limited
- Always Ethical
- AMP Investment Management (N.Z.) Limited
- Aspiring Asset Management Limited
- Fisher Funds Management Limited
- Generate Investment Management Limited
- Kernel Wealth Limited
- Mercer (N.Z.) Limited
- Milford Asset Management Limited
- Mint Asset Management Limited
- New Zealand Investment Portfolio Management Limited
- Salt Investment Funds Limited

Appendix 2 – Correspondence between B.I.G. and FMA on levies in 2020

Letter from B.I.G to FMA and MBIE

24 June 2020

Dear […]

Feedback on Government decision to increase FMA's funding and levy settings 2020

We are writing to provide MBIE and the FMA with feedback on the decision to increase the FMA's funding and levy settings.

The MIS managers ("Managers") listed at the foot of the letter continue to be supportive of the FMA being a well-resourced regulator, provided costs are reasonable and fairly apportioned. Our feedback focuses on how FMA costs are influenced by New Zealand's co-regulatory model. For Managers, this unique model is an important part of the context for our thinking about FMA funding and the associated question of regulatory burden.

We note that some members of our forum have been conflicted from commenting as they are both MIS managers and DIMS retail providers.

Value of co-regulation is unclear or, worse, negative
The IMF has drawn attention to the outlier nature of having both a regulator and a supervisor overseeing MIS against international norms by describing supervisors as "a particular feature of the

New Zealand regulatory landscape"[1]. As such, to justify any cost arising from this model – regardless of whether industry or Government pays it and in what proportion – the onus is on the Government and, to a lesser extent, the FMA to explain:

1. why the regulatory model has been adopted, and
2. how it is more effective or efficient (or both) than a regulatory-only model for Managers and their investors.

Unfortunately, the Government has made no mention of the function of supervisors – or their value proposition – in its decision about how FMA costs should be recovered. Nor does the FMA's description of its activities explain what supervisors do. Worse, it is clear that the different levies charged for DIMs providers and Managers in the co-regulatory model *detracts* value if taken at face value.

Managers perform a very similar role to DIMs providers. The only significant difference between the two types of entity is that DIMs providers are overseen by the regulator only. If the additional layer of regulation for Managers adds value – which would have to be by reducing the risk posed by Managers – we would expect to see Managers paying a lower levy than DIMS providers.

However, the opposite is true – as set out in the levy table below. (Note the figures used are the only ones where the FUM categories between Managers and DIMS providers align. Unfortunately, figures have not been provided for levies beyond 2020/2021.)

	MIS Manager	DIMS retail providers
Assets exceed $2 billion	$160,000	$57,000
Assets exceed $500 million but not $2 billion	$100,000	$24,000
Assets exceed $100 million but not $500 million	$26,500	$8,100

This levy table provides support for the effectiveness and efficiency of FMA-only supervision. But it undermines a co-regulatory model and supervisor oversight generally.

From this, we see four logical outcomes:

1. The co-regulatory model is scrapped, Managers have regulator-only supervision and pay levies the same as – or substantially closer to – DIMS providers at comparable levels of assets under management.

2. A case is made by the Government and FMA for supervisors adding value through 'taking over' some or all of the FMA's oversight responsibilities for Managers (other than enforcement action). This is effectively a supervisor-only or supervisor-skewed model with a similar effect on levies, assuming the Government case includes supervisors are equally effective as the FMA, at the FMA responsibilities they assume.

3. A case is made by the Government and FMA that Managers pose significantly greater risk than DIMS providers, either inherently or because we resist or attempt to avoid regulatory engagement, requiring double regulation. We are not aware of the Government or FMA holding or communicating this view.

[1] Para 19, IMF Country Report Number 17/117, New Zealand, Financial Assessment Program, Technical Note – Fund management – Regulation, Supervision, and Systemic Risk Monitoring (May 2017).

4. There is an acceptance that not enough thought has been put into how the co regulatory model can be made to work efficiently and effectively and that work now needs to be undertaken to ensure that combined oversight is joined up, as effective as and no more costly than direct regulation.

The Manager / DIMS split is not the only allocation issue. No explanation was given for what principles, if any, were used to determine how cost recovery was allocated across sectors. When Managers compete with entities from other sectors – as explained further in the following section – how cost recovery is allocated is as important as the total sum to be collected, in terms of evaluating reasonableness.

The lack of any explanation materially impeded our ability to submit effectively to the consultation. This is surprising and disappointing when, typically, the FMA is genuinely committed to and skilled at engaging with the sector.

The burden of double regulation on competitiveness

Managers' situation relative to DIMS is compounded by other competitors – such as Australian-based fund managers offering product into this market and, looking ahead, offshore managers with Passport access doing the same – who are not burdened by double regulation. This is despite them doing a similar job and posing a similar risk.

We also compete for investors with banks and other larger horizontally integrated businesses. While bank wealth units require a supervisor, the broader business does not, and greater scale greatly assists their ability to absorb the cost.

A significant levy increase necessitates that market participants divert resources away from these innovations, ultimately providing a less vibrant and diverse range of financial products for investors and hampering the sophistication of New Zealand's financial market compared to other jurisdictions.

The impact on investors, of unnecessary co-regulation

Finally, to repeat a point made in our submission (and in some individual submissions by Managers) : it has often been non-bank businesses with a strong incentive to disrupt (ie our group) in order to break into the market which have introduced many of the innovations to improve the sector and provide more choice for investors, including:

- pricing with zero fees for low-balance customers
- ethics-focused investments
- alternative asset classes
- digital advice tools.

Imposing more cost on innovators is a drag on innovation if it diverts resource away from new initiatives or deters entry by disrupters.

Further analysis of cost/benefit of increased regulation

We consider that the maturing of the regulatory landscape requires greater cost/benefit analysis of the rising cost of regulation for the industry overall as well as a second look at the co-regulatory model. This is particularly pertinent in the current low yield environment in which every cent of cost proportionately eats into investor returns more than it would have done in the past. We also note that the levy increase does not include another levy already announced in relation to conduct and culture regulation.

We would be happy to speak to this submission in person.

Reply from FMA

Dear Simon

Apologies for the delay in responding to your email as I have been away on leave.

Many thanks for the feedback from your group on the recent review of FMA funding and levies.

The issues you raise around the Supervisor model and the structure of regulation in New Zealand are ones in which the decision-maker is not the FMA, but the Ministry of Business, Innovation and Employment and the broader Government of the day. The FMA cannot and does not set policy.

The FMA has engaged with MBIE on your letter, and they agree that the concerns you raise around the Supervisor system sit with MBIE, as steward of the regulatory system, rather than the FMA. MBIE will be reaching out to you to discuss the best way to further understand your concerns.

Finally, I note your thanks to FMA staff for their work engaging with you during the COVID-19 pandemic. The co-operation between participants and regulators was a key feature of New Zealand's response to the pandemic and I commend you for the way you and those you represent engaged with both the FMA and broader Government during the outbreak.

I am sure we will catch up shortly as both travel and industry events resume in Auckland.

Kind Regards
Rob

ENDS