ICNZ Insurance Council of New Zealand
Te Kāhui Inihua o Aotearoa

Insurance Council of New Zealand
Level 2 Asteron House, 139 The Terrace,
Wellington 6011
Tel 64 4 472 5230
Email icnz@icnz.org.nz
Fax 64 4 473 3011
www.icnz.org.nz

9 November 2022

Financial Markets Team
Small Business, Commerce and Consumer Policy
Building Resources and Markets
Ministry of Business, Innovation and Employment
Wellington

By email: FinancialConduct@mbie.govt.nz

Dear Sir/Madam,

ICNZ submission on Exposure Draft Regulations regarding Sales Incentives

Thank you for the opportunity to submit on the Exposure Draft Regulations regarding Sales Incentives.

By way of background, the Insurance Council of New Zealand - Te Kāhui Inihua o Aotearoa (**ICNZ**'s) members are general insurers and reinsurers that insure about 95 percent of the New Zealand general insurance market, including about a trillion dollars' worth of New Zealand assets and liabilities. ICNZ members provide insurance products ranging from those usually purchased by individuals (such as home and contents, travel and motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability, business interruption, professional indemnity, commercial property and directors and officers insurance).

Briefly, the main points that ICNZ wishes to raise in respect of these draft regulations are:

- Scope: the regulations have been broadly drafted in a way that we believe goes beyond the intent of the Cabinet decision. This broadness is not only with respect to the determination of what is a prohibited incentive, but also who is a relevant person.
  - We have provided examples of how we believe the wording, especially the use of "indirect", reaches beyond the frontline salespeople and their direct managers and can capture senior managers and executives, who have been identified as exempt in the Cabinet decision. Also, as applied to incentives, almost any form of business performance measure will ultimately link to the value or volume of product sales.
- Clarity: in some instances, the wording relies heavily on a knowledge of the Cabinet decision and/or the consultation paper to enable clear interpretation. We have suggested some minor wording changes to seek clarity.
- Examples: related to the issue of clarity, we have provided various examples of situations that we believe will be captured by the regulations even though we do not think this was the intent of the Cabinet decision. The examples provided in the draft are very straightforward but, as we describe, the many different incentive/person possibilities require examples of incentives that would not be allowed as well as those that are allowed.

We attach as an appendix the official MBIE response form. As always, we are happy to discuss any of our responses in person.

Please contact Greig Epps (greig@icnz.org.nz) if you have any questions on our submission or require further information.

Yours sincerely,

Greig Epps
Regulatory Affairs Manager

APPENDIX A – FEEDBACK FORM

Prohibited incentives	
1	*Do you consider that the draft regulations give effect to Cabinet's decision to prohibit sales incentives based on volume or value targets? If not, why not?*

We believe there are areas that require clarification to ensure that the regulations give effect to Cabinet's decision. As currently drafted, the regulations leave uncertainty as to how the prohibition will apply.

We note that in 2022, Cabinet "*agreed that financial institutions and intermediaries be prohibited from offering sales incentives based on volume or value targets to their employees (except senior managers and executives), agents and intermediaries*".

The broader framing used in the draft regulations creates uncertainty as to the scope of the prohibition on "*offering sales incentives based on volume or value targets*":

- It is not clear whether the draft regulations are limited only to incentives calculated by reference to the volume or value of products sold by the person in question, or whether wider financial measures *indirectly* related to volume or value targets (e.g., profit measures, broader business measures and even some customer measures) are intended to be caught by the prohibition; and
- The extent to which it effectively excludes senior managers and executives from the prohibition (refer to further comments in relation to question 5 below).

The uncertainty arises due to the attempt to comprehensively (but, we think, unnecessarily) capture all possible connections between a salesperson's remuneration or recompense and volume/value targets and thresholds.

As set out in the consultation paper, "*Cabinet decided to prohibit sales incentives that are based on volume or value targets as these types of incentives create a strong conflict between the interests of consumers and the interest of the person eligible to receive the incentive, which increases as the persons nears the target*". Given the commentary in paragraphs 17 and 18 of the consultation paper, the prohibition would continue to apply even if the following controls were in place to mitigate the risk of conflicts of interest:

a) The business goal based on growth/profit is only part of an overall balanced scorecard.
b) The business goal is subject to a maximum weighting in the scorecard.
c) The balanced scorecard includes genuine customer measures that must be satisfied before any incentive can be paid (i.e. behavioural gateways).
d) Any incentive that is paid on achievement of business goals is discretionary and outside the control of the employee; and
e) There is no guarantee of any incentive being paid or communication to the employee of the potential amount of any incentive at the outset.

Applying the prohibition to business targets only indirectly linked to sales and which are subject to the controls as set out in paragraphs a) to e) above, we believe goes well beyond Cabinet's intention.

2	*Do you have any comments on the examples chosen of a prohibited incentive and a non-prohibited incentive?*
	The use of examples in the regulations is generally welcomed although it would be beneficial to provide more than one example of what is *not* prohibited. The examples provided in the draft regulations are simplistic given the extensive variety of remuneration structures that exist within FIs and between FIs and their agents and intermediaries. **Need for additional examples to address ambiguity** In the case of proposed clause 237B, the examples could be used to provide greater certainty as to the application of the regulated prohibitions and *what types* of incentives are prohibited. Rather than using the examples to demonstrate the obvious, they should be used to provide clarity about how the prohibition is applied in situations where it is unclear. The second example, which makes clear that linear incentives are not prohibited, provides important certainty for financial institutions and intermediaries in relation to the conventional commissions that underpin the distribution of intermediated insurance products and much of the related financial advice provided in New Zealand. It is necessary to clarify what it means for an incentive to be calculated by "*indirect*" reference to a volume or value-linked target or threshold, and an example to address the boundary between incentives linked to individual performance (the relevant person's actions) as opposed to team or organisation-wide performance.
3	*Do you have any other comments on the way the draft regulations define prohibited incentives?*
	Scope of definition unclear The definition of "prohibited incentive" is extremely broad and has the potential to capture incentives where the risk of a conflict of interest at the point of sale is extremely low. Regulation 237B provides that an incentive is a prohibited incentive if it is determined or calculated in any way by reference (directly or indirectly) to a target or other threshold. The breadth of the term "indirectly" means that business objectives or targets that relate to enterprise-wide performance could be prohibited, which we do not believe is the intention of Cabinet's policy decision. The consultation paper states: "*It is less common for senior managers and executives (particularly in large organisations) 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)*". That commentary implies that target-based incentives relating to enterprise-wide performance – such as increases in market share – are not intended to be prohibited. However, this is not clear in the regulations and market share is arguably an incentive "*…calculated in <u>any way</u> by reference (directly or <u>indirectly</u>) to a target or other threshold that relates to the volume or value of the services or products…* (emphasis added)". For example, while we acknowledge that a target that is based on gross written premium ("GWP", a component of revenue) would be prohibited for "relevant people", on the current drafting it seems that a target that is based on profit (being revenue less expenses) could also be prohibited as it is indirectly calculated by reference to GWP. This would

prevent businesses from being able to set relevant and appropriate business goals necessary to facilitate business growth and enable the long-term sustainability of financial institutions.

Target based metrics related to business unit or overall business profitability or revenue (e.g. with reference to an aggregated loss ratio, overall profit, market share or budgeted costs) are calculated taking into account a number of factors (e.g. claims costs, business and administration costs, inflation etc) and may include both consumer and non-consumer business. An individual's ability to influence these results are minimal, have only an indirect connection with sales targets, and are unlikely to result in a conflict or potential conflict with consumer interests. To provide clarity, we recommend these metrics are included in the examples of incentives not prohibited, or they are explicitly excluded from the prohibition (or both).

Profit share arrangements, which include the cost of claims during the relevant financial year, are another example where it is implausible that an individual would be conflicted to influence the outcome given the distance between their activity and the achievement of the goal, particularly where the assessment of whether a profit can be 'shared' can usually only be calculated after the end of the financial year. However, profit share arrangements are arguably indirectly related to the volume or value of the services or products and contain a target component.

We do not believe that the examples of incentives structures described above create any actual or potential adverse effects on consumers' interests and instead help to drive sustainable productivity within insurer businesses. Therefore, they should not be subject to the prohibition, and this should be clarified within the regulations.

We note that sales-based incentives that do not include a volume or value target, including those provided to frontline staff are not prohibited, although financial institutions (FIs) are still subject to the requirement to design and manage incentives to mitigate actual or potential adverse effects on consumers[1]. This may result in non-target-based linear sales incentives (identified as an issue in the course of the FMA and RBNZ "conduct and culture" reviews) being reintroduced for frontline staff along with controls to adequately mitigate potential or actual conflicts (eg within a balanced scorecard).

Proposed changes

The repeated reliance on indirect relationships creates unnecessary uncertainty, and it is very likely to result in the prohibition being applied far wider than what Cabinet intended. This is particularly the case for senior managers, who Cabinet sought expressly to exclude from the prohibition.

The following amendments are suggested to the definition of "*prohibited incentive*" in clause 237B:

- Removal of the words "*in relation to relevant services or associated products*". That duplicates the wording already embedded in the definition of incentive in section 446M of the Financial Markets (Conduct of Institutions) Bill (*CoFI*).
- To clarify the scope of the prohibition which, as currently drafted, is not clear:
  - The words "*the volume or value of the services or products*" are unqualified – **what** volume or value is referred to? For instance, is it the volume or

[1] Section 446J(1)(i)

value of the services or products ***that the person is involved in providing to a consumer***[2]?

- The scope of the words "*directly or indirectly*" – presumably refers to incentives payable to people leaders, where the person's entitlement to the incentive is calculated by reference to the performance of that person's team (as opposed to their own performance).[3]

  However, it could also apply to (for example) incentives based on increases in market share. The consultation paper implies[4] that the prohibition is not intended to capture incentives based on organisation-wide metrics, such as increases in market share. Given that policy decision, the draft incentives should be clarified so as not to unintentionally apply to incentive structures of that type.

- Adding the words "sold or distributed to a consumer" or similar "after "services or products" at the end of clause 237B would make this consumer focus clearer, prohibiting sales incentives on consumer products that might give rise to unfair conduct towards the consumer, and not on other broader business measures that relate to the performance of the entire business.

We refer to ICNZ's previous submission dated 18 June 2021 in response to MBIE's consultation on the "proposed regulations to support the new regime for the conduct of financial institutions". As set out in ICNZ's response, we believe volume- or value-based targets where it can be shown that any actual or potential adverse effects on consumers' interests have been mitigated or which have positive outcomes for consumers, should be excluded from the prohibition.

We also note a recent judgement in Australia (*Australian Securities and Investments Commission v Commonwealth Bank of Australia* [2022] FCA 1149) that supports focusing the prohibition on incentives that might actually *influence* an employee's actions. In the Commonwealth Bank of Australia (CBA) case, it was noted that frontline staff could not reasonably have been influenced by the remuneration agreement (between two separate legal entity business units within CBA) because they had no knowledge of the supposed benefit.

Clauses 237C and 237D

In the event of dispute or ambiguity, the Courts will look to clause/section headings to assist in the interpretation of the statute.[5]

The headings of both clauses 237C and 237D should be amended to incorporate the words "*prohibited incentive*". As drafted, they incorporate what is effectively an abbreviated definition of prohibited incentive, which could in principle affect the interpretation of clause 237B.

Suggested amendments as follows:

237C Financial institution must not offer or give prohibited incentive~~s based on volume or value targets~~

[2] To use the language of section 446M(1)(a).
[3] Per Example 2 in section 446M(1).
[4] Paragraph 24.
[5] Section 10, Legislation Act 2019.

And:

237D Intermediary must not offer or give prohibited incentives ~~based on volume or value targets~~

Recipient of incentive

4 *Do you have any comments on the definition of 'relevant person' in relation to a financial institution or an intermediary?*

Paragraph 19 of the consultation paper suggests that the proposed definition of "relevant person" excludes senior managers and executives. That is not explicitly the case. Neither regulation 237C or 237D excludes senior managers and executives from the words "*employee of the financial institution*". Accordingly, the regulations should specifically – and clearly – exclude managers and executives to avoid unintended consequences.

Excluding senior managers and executives

Under section 446M(1) of the Financial Markets Conduct Act 2013 (FMCA), the definition of "incentive" captures persons who are directly or indirectly involved in the provision of the service or the products. Paragraph 24 of the consultation paper acknowledges that Cabinet's intention is to exclude "senior managers and executives" from the incentives prohibition. However, without specific provisions excluding senior managers and executives from the prohibition, inadvertently the prohibition arguably applies to them because of the reference to "indirectly".

Because section 446M(1) applies where a person is involved "indirectly", it could capture persons – including executives and senior managers – that have a role to play in "arranging" a contract of insurance, even if this is unrelated to the specific transaction. For example, in an insurance context, this could potentially include an underwriter who liaises with brokers in relation to the insurer's products, a product line manager who oversees a class of products, a distribution manager who manages the insurer's relationship with intermediaries, and even the chief executive officer who oversees the entire business.

We do not believe that it is Cabinet's intention to capture such persons.

In the absence of specific regulations, reliance would need to be placed on the consultation paper itself to determine the scope of the persons who are captured by the incentive prohibition. This does not provide sufficient certainty, especially as the consultation paper does not define senior managers and executives (noting that "senior manager" is defined narrowly in the FMCA).

It is well established in case law considering causation that the word "indirectly" allows for a more remote link in the chain of causation than the proximate and immediate cause. Within an insurer with multiple divisions and layers of management, who is and who is not "indirectly" involved in the provision of the service/product is not clear at all. That means that a commission, benefit, or other incentive paid to a senior manager or executive who is *indirectly* responsible for procuring the relevant services would meet the definition of "incentive" in section 446M and therefore potentially be subject to a prohibition. For example, an executive responsible for approving the provision of services negotiated by

employees in that executive's business unit has (at least arguably) indirectly arranged that contract.

The definition of 'relevant person' requires further clarity to:

- ensure that the incentives prohibition applies to the areas of the business which may see strong conflicts between the interests of the person eligible to receive the incentives and consumers, such as teams that are responsible for sales of a product to consumers; and
- ensure FIs can identify which level of management is not subject to the prohibition given the draft regulations currently do not attempt to expressly exclude senior managers and executives. We have elaborated on this in response to question 5 below.

Suggested amendments
To minimize uncertainty, we recommend the treatment of employees under clause 237C is consistent with that of agents and intermediaries. This could be simply achieved by redrafting 237C as follows:

> **237C Financial institution must not offer or give incentives based on volume or value targets**
>
> For the purposes of section 446K of the Act, a financial institution must not offer or give a prohibited incentive to a relevant person.
>
> In this regulation, relevant person, in relation to a financial institution, means—
>
> (a) an employee of the financial institution *that is involved in the provision of the financial institution's relevant services or associated products*; or
>
> (b) an intermediary that is involved in the provision of the financial institution's relevant services or associated products; or
>
> (c) an agent of the financial institution that is involved in the provision of the financial institution's relevant services or associated products.

The same change could be made to clause 237D also.

Clarification is also needed as to the extent to which the exemption for senior managers/executives will apply to agencies/intermediaries. If, for example, an intermediary or agent contracts with third parties (e.g., a bank) in New Zealand, then does the exemption follow down to that level of relationship; presumably it should?

It is submitted that mere referral arrangements should be excluded from the prohibition. External actors who refer their customers to FIs are merely identifying an opportunity for their customer to have an insurance conversation with an insurer who is licensed to provide financial advice and is subject to all relevant regulatory requirements (including a Code of Professional Conduct). Not prohibiting referral arrangements increases customers' ability to access financial advice and aligns with the FMA's view that customers having access to quality financial advice can lead to better customer outcomes. The risk of a conflict is also mitigated by the referral to a FI who will fall in scope for the CoFI sales incentive regulations.

	Exclusion of senior managers and executives from the incentive prohibition
5	*Do you have any comments on the application of the draft regulations to senior managers and executives?*

We note that the agreed policy intent of Cabinet is to exclude senior managers and executives from the prohibition on sales incentives. This was in recognition that:

- the greatest conflict of interest is likely to occur at the mid-to-lower levels of an organisation where individuals are directly involved in distribution of the product/service to customers; and
- to allow for incentives to be offered as part of reasonable remuneration at more senior levels where performance and growth of the business requires a focus on achieving financial metrics that are inherently driven by sales.

The consultation paper makes clear that instead of addressing this directly and explicitly exempting senior executives, the drafting approach is to achieve this intent through relying on the interpretation of the FMCA (sections 446M(1) and 446Q(3)) to mean that senior managers and executives are not '(directly or indirectly) involved in' the provision of the service or the products to customers. As discussed above in response to question 4 this does not provide certainty and relies on reading 'indirectly' narrowly so that an immediate manager is (potentially) included (as per the second example under clause 237B) but their manager or manager plus one is excluded. This inevitably creates uncertainty (i.e., is anybody other than the person interacting with the customer 'indirectly' involved), and if so where and how that line is drawn).

We note that the examples in section 446M(1) of the FMCA make clear that the person engaging with the consumer, and their manager (if there are team level incentive targets in place), are 'involved in' in the provision of the service/product. These examples are useful in other respects, but they do not make clear the limits of '(directly or indirectly) being involved in'. Specifically, the second example does not make the boundary clear: for example, are incentives for higher level managers that have more broadly scoped target-related incentives within the scope of the word '*indirectly*'? By way of further illustration, it is unclear whether the following would be subject to the proposed prohibition:

- A senior insurance underwriter who offers revised terms to a consumer via a broker who is acting on the consumer's behalf.
- A Regional Manager who works for a fully intermediated general insurer (i.e. with no direct sales to consumers) and manages a team of Business Development Managers who provide support for independent brokers who act on behalf of the consumer. Neither the Regional Manager nor the Development Managers have direct contact with consumers.
- A Manager responsible for pricing, distribution or underwriting, in a large fully intermediated general insurer business (i.e. with no direct sales to consumers).
- A Manager whose direct reports are in turn responsible for managing a team of salespersons in a large direct general insurer.

To give effect to Cabinet's decision to exclude senior managers and executives from the prohibition, we consider it would be more effective and provide more certainty if the prohibition only applied to:

	(a) a person (**A**) who has direct contact (whether in person, on the phone, via a website or in writing) with a consumer or their agent; and (b) A's direct leader or manager. This would allow FIs to easily assess whether someone is consumer-facing and apply the prohibition to that person and their direct leader/manager. Restricting the prohibition to frontline staff and their managers would also allow a FI to apply the prohibition only to the consumer part of its business. Without more clarity in the drafting of the regulations, FIs could find themselves in breach of the prohibition, and as is often the case if regulations are not sufficiently clear from the outset, the matter will be determined though costly and time-consuming legal proceedings. This outcome can be avoided if care is taken now to provide clarity, which will also reduce the risk of FIs designing incentive schemes in an unduly cautious way not intended by Cabinet. Given this analysis, we consider that at the very least the regulations need to be revised including as outlined above in response to Question 4 (although even this may not fully resolve the issue).
6	*Do you have any other additional general comments on the exposure draft regulations?* *For example, do you see any unintended consequences arising from the draft regulations in relation to any other matters? Are there any areas where the application of the draft regulations is unclear and could benefit from additional examples or guidance?*
	As noted in comments above, there is a strong concern among some ICNZ members regarding the application of the Regulations to agents and intermediaries. They fear that the current Regulations are high-level and could be left open to interpretation. Firstly, it seems clear that the Regulations are focused on conflicts of interest at the point of sale, and therefore prohibitions around volume/value-based insurance product incentives are targeted at frontline staff (i.e., 'relevant' persons). As currently drafted the prohibition may be so far reaching that FIs find it difficult to incentivise staff to drive business productivity, growth and support the long-term sustainability of their businesses. This could lead to reductions in the products/services available to customers, as businesses look to remain sustainable. FIs are still subject to the overarching duty to design and manage incentives to mitigate or avoid the actual or potential adverse effects of incentives on the interests of consumers. Therefore, it is more appropriate to have a narrower prohibition which still gives effect to Cabinet's decision rather than an unnecessarily wide prohibition which may have unintended consequences on the growth and long-term stability of the financial services industry. We would also like to get clarity with respect to the connection between the sale of a non-insurance good and the ancillary offer of insurance products to cover risks to that initial good sold. The vendor of the good (not an insurer or FI) has a primary incentive to sell their goods (eg cars), and they receive a payment from the insurer only if they are also able to sell a related insurance product. The value of the insurance product depends on the value of the vendor's good and thus the level of payment from the insurer to the vendor/intermediary will differ depending on the good sold. We see this as different to the example in the MBIE consultation paper which discussed a *mortgage* broker receiving commissions based on the value of *mortgages* arranged because in that situation the intermediary is selling the FI's

product (mortgage) but the car dealer sells their own product (cars) and supplies insurance as a convenient extra to their customers.

Other Comments

None.