



COVERSHEET

Minister	Hon Kris Faafoi	Portfolio	Commerce and Consumer Affairs
Title of Cabinet paper	Release of Options Papers on Insurance Contract Law and Conduct of Financial Institutions	Date to be published	1 July 2019

List of documents that have been proactively released

Date	Title	Author
10 April 2019	<i>Release of Options Papers on Insurance Contract Law and Conduct of Financial Institutions</i>	<i>Office of the Minister of Commerce and Consumer Affairs</i>

Information redacted

NO

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In Confidence

Office of the Minister of Commerce and Consumer Affairs

Chair, Cabinet Economic Development Committee

Release of Options Papers on Insurance Contract Law and Conduct of Financial Institutions

Proposal

1. This paper seeks approval to release options papers for public consultation on the reviews I am undertaking of Insurance Contract Law and the Conduct of Financial Institutions.

Executive summary

2. I propose to release two options papers to seek feedback on potential options to address issues related to insurance contract law and the conduct of financial institutions.
3. The feedback received on the two options papers will help to inform final policy decisions.

Insurance Contract Law Review

4. The key issues that have been identified around insurance contract law include: the current law is fragmented and outdated, the duty on insureds to disclose is onerous with harsh consequences, the insurance-specific exceptions from the unfair contract terms prohibition are problematic, and insurance contracts are complex and hard to understand.
5. I am seeking feedback on potential options to address these issues, including:
 - a) amending the duty of disclosure – e.g. to place the onus on insurers to ask the necessary questions when someone is taking insurance out,
 - b) removing the insurance-specific exemptions from the unfair contract terms prohibition and instead tailoring the general exemptions to insurance, and
 - c) ways in which insurance contracts could be made easier to understand.

Conduct of Financial Institutions Review

6. The key issues that have been identified around the conduct of financial institutions include: there is a significant imbalance of knowledge and power between financial institutions (such as banks and insurers) and customers, a lack of focus on good customer outcomes, weaknesses in the governance and management of conduct

risks, conflicted remuneration leading to a focus on sales rather than customer outcomes and a general gap in regulators' ability to address these issues.

7. This paper sets out an initial preferred package of proposals to address these issues (see page 27 of the Conduct of Financial Institutions Options Paper), as well as a range of other options for consideration.
8. The preferred package includes options such as:
 - a) A duty to consider and prioritise the customer's interest, to the extent reasonably practicable.
 - b) A ban on target-based remuneration and incentives for in-house staff and intermediaries (including soft commissions that are rewarded when a target is met).
 - c) A duty to design remuneration and incentives in a manner that is likely to promote good customer outcomes.
 - d) A duty to ensure insurance claims handling is fair, timely and transparent.
 - e) Making directors and senior managers personally liable if their entity does not meet these duties.
 - f) A product banning/stopping power for the regulator to prohibit or stop the distribution of specific financial products if they result in particularly poor customer outcomes.
 - g) A range of monitoring powers, enforcement tools and penalties available for the FMA to use to deter misconduct. Tools could include public warnings, stop orders, direction orders and civil liability.
 - h) Strong civil pecuniary penalties for noncompliance.

Background

9. Banking and insurance services play an integral role in people's lives. Banking services are essential to enable individuals to effectively participate in society. Insurance is one of the primary ways that consumers and businesses can manage unforeseen risks – and is usually a prerequisite when consumers take out a mortgage to buy a home.
10. Given this, it is essential that regulation of the financial sector remains up to date and fit-for-purpose. Effective regulation in this area will ensure that the sector performs as expected, and contributes to a stable and growing economy.
11. Insurance contract law in New Zealand is fragmented and outdated. I released an issues paper for public consultation on insurance contract law in May 2018. MBIE received around 120 submissions, which were analysed to understand the extent of the problems and to help develop options.

12. As a part of the insurance contract law (ICL) review and consultation, I also explored issues around the conduct of insurers – including concerns about claims handling following the Canterbury earthquakes. Since then, the Australian Royal Commission into misconduct in the banking, superannuation and financial services Industry (ARC) has shone a spotlight on conduct issues in Australia relating to both insurers and banks. In response to the Australian Royal Commission, the Reserve Bank of New Zealand (RBNZ) and the Financial Markets Authority (FMA) reviewed the conduct and culture of banks and life insurers in New Zealand.
13. The FMA/RBNZ report on bank conduct and culture was released in November 2018 and the report on life insurer conduct and culture was released in January 2019. On 29 January Cabinet noted that the issues raised in the Life Insurer Conduct and Culture report are similar to those highlighted through the Banking Conduct and Culture report, submissions on the ICL issues paper and the ARC [CAB-19-MIN-0011 refers]. The issues identified are serious and Cabinet noted that the public would be consulted this year on options to address the issues [CAB-19-MIN-0011 refers].
14. Further regulation of financial sector conduct is in line with international developments since the Global Financial Crisis in 2008. Regulators around the world have been working to address broader issues like banks' market conduct, the suitability of financial products sold to customers, and the broader repercussions of an institutional culture that rewards excessive risk-taking with little accountability on the downside. Poor conduct can harm customers, damage a financial institution's reputation, and reduce trust in the financial system.
15. The financial sector is currently undergoing a raft of significant regulatory changes and the proposals in these options papers are substantial. Given the potential impact of the proposed changes, the options papers will go a long way towards ensuring that there is a well-considered response which adequately addresses the problems.

Key Features of the Insurance Contract Law Options Paper

16. The Insurance Contract Law Options Paper describes problems with the existing law, possible options for solving them, and the costs and benefits of those options.
17. The different sections of the options paper include:
 - a) Options to change the law regarding insureds' duty of disclosure. Under the current law insureds often do not understand their disclosure duties and often cannot reasonably be expected to know what they are required to disclose. Options to change the duty of disclosure include:
 - i. replacing the disclosure duty with a duty to take reasonable care not to misrepresent (i.e. insurers would have to ask the right questions and the policyholder must accurately answer the questions), or
 - ii. replacing the disclosure duty with a duty to disclose what a reasonable person would know to be relevant,

The new disclosure duty could be accompanied by options such as:

- i. a requirement for life and health insurers to use medical records to underwrite insurance, and
 - ii. requiring non-disclosure to be deliberate or reckless before insurers can decline claims.
- b) Options in relation to unfair contract terms. Currently there are a number of insurance-specific exemptions from the unfair contract terms prohibitions in the Fair Trading Act and officials have been looking at whether these are still suitable. There are a range of options in the paper, including an option to remove the insurance specific exemptions and make it clear how the general unfair contract terms provisions apply to insurance. This is consistent with the ARC recommendations to apply unfair contract terms provisions to insurance contracts. Insurers are likely to oppose change and argue that the status quo is necessary to provide certainty that key terms defining the risks they accept will not be challenged through the courts.
- c) Options in relation to consumers' ability to understand and compare insurance policies. Consumers often struggle to understand their insurance policies because insurance policies are long, complex documents written in legal terms. Options include:
 - i. requiring plain English insurance policies,
 - ii. requiring core policy wording to be clearly defined,
 - iii. requiring a summary statement to be provided, and
 - iv. regulations enabling comparison websites for insurance policies.
 - v. Information disclosure obligations.
- d) Options in relation to a number of other miscellaneous issues with insurance contract law. These include:
 - i. a number of technical legal issues that affect the ability of insurers to accurately price risk,
 - ii. a suggested codification of the duty of utmost good faith, and
 - iii. suggestions for consolidating the various insurance contract statutes.

Likely public reaction to the insurance contract law options paper

- 18. This paper is likely to be generally well received by industry and consumer stakeholders. The issues regarding disclosure and some of the more technical problems with the law have been discussed over many years. Other countries with similar insurance laws have already moved to address similar issues.
- 19. I anticipate industry opposition to options that would change the insurance-specific exemptions from the general prohibition on unfair contract terms. It will be important that we listen to both sides of the argument. The ARC has recommended removing

Australia's equivalent exemption so this is a battle that insurers will be fighting on both sides of the Tasman.

Key Features of the Conduct of Financial Institutions Options Paper

20. The Conduct of Financial Institutions Options Paper describes problems with the conduct of financial institutions in New Zealand, possible options for resolving the issues, and the pros and cons of the options.
21. My initial thinking is that the options should apply to banks and insurers. However, I am also seeking feedback on whether there are other financial institutions that provide similar services and face similar conduct risks which should also be subject to the final policy proposals.
22. At a high-level, the problems that we are addressing often stem from the significant imbalance of power between financial institutions and their customers. There is also a general gap in regulators' ability to take action when problems are identified.
23. The paper sets out a broad range of options along with an initial preferred package of options. The initial preferred package includes:
 - a) Overarching duties to govern conduct:
 - i. A duty to consider and prioritise the customer's interest, to the extent reasonably practicable.
 - ii. A duty to act with due care, skill and diligence.
 - iii. A duty to pay due regard to the information needs of customers and to communicate in a way which is clear and timely.
 - iv. A duty to manage conflicts of interest fairly and transparently.
 - v. A duty to ensure complaints handling is fair, timely and transparent.
 - vi. A requirement to have the systems and controls in place that support good conduct and address poor conduct (the options paper specifies a number of examples, such as prioritising investment in systems and processes to proactively identify and address issues that may require remediation).
 - b) Directors and senior managers would be personally liable if their entity did not meet these duties.
 - c) Measures to address conflicted remuneration:
 - i. A duty to design remuneration and incentives in a manner that is likely to promote good customer outcomes. This duty focuses on the outcomes of the remuneration and incentive structures, rather than the form. Compared to banning certain types of remuneration or incentive, this option means that institutions cannot just design new incentive structures that have the same effect as a banned form of remuneration.

- ii. Ban target-based remuneration and incentives, including soft commissions (this would apply to both in-house staff and to intermediaries). An example of an in-house target-based incentive could be a bonus received by a staff member for signing up 20 customers to the bank's KiwiSaver products. An example of a soft commission to an intermediary could be qualifying for a trip to Queenstown if an adviser is in the bank or insurer's list of top 50 advisers by sales volume/value.
- d) An obligation regarding insurance claims handling:
- i. A duty to ensure insurance claims handling is fair, timely and transparent.
- e) Measures to ensure financial products are suitable for customers:
- i. A requirement for manufacturers to identify the intended audience for a product and a requirement for distributors to have regard to the intended audience when placing the product.
 - ii. Give the regulator the ability to ban/stop the distribution of specific products if they have particularly poor customer outcomes (e.g. specific insurance policies with particularly poor successful claims rates).
 - iii. A duty on manufacturers to take reasonable steps to ensure that the sales of their products are likely to lead to good customer outcomes.
- f) A robust enforcement package:
- i. Empowering and appropriately resourcing the FMA to monitor and enforce compliance.
 - ii. A range of monitoring powers, enforcement tools available to the regulator. Tools could include public warnings, stop orders, direction orders, enforceable undertakings and civil liability.
 - iii. Strong civil pecuniary penalties to deter misconduct.
 - iv. Regular reporting of summary data about the industry – such as remediation activities, complaints and reasons for declined insurance claims etc.

Connections with other regulation and regulatory reviews

24. Any new regime to govern the conduct of financial institutions will need to interact with other financial markets regulation. This includes, among other things:
- a) the Financial Markets Conduct Act 2013,
 - b) the changes being made to New Zealand's financial advice regime via the Financial Services Legislation Amendment Bill (FSLAB),

- c) the Credit Contracts and Consumer Finance Act 2003 (CCCFA) and the changes being made to this through the Credit Contract and Consumer Finance Amendment Bill, and
 - d) the Reserve Bank Act 1989 and the changes being considered through the review of this Act.
25. MBIE officials are working closely with the relevant regulators and policy agencies to consider potential regulatory interactions and overlaps, and ensure regulatory coherence in the policy proposals that are developed.
26. The findings and recommendations of the public inquiry into EQC may also be relevant. MBIE officials are in contact with the inquiry's secretariat and will share any relevant findings.

Likely public reaction to the conduct of financial institutions options paper

27. This paper is widely anticipated and represents a significant expansion in how New Zealand regulates conduct in the financial sector. If implemented, the proposals would affect many industry stakeholders and, ultimately, nearly all consumers. I expect the paper to attract considerable public attention and debate and a wide variety of views to be expressed.
28. In particular, options suggesting regulation of the structure of commissions or other incentives would significantly disrupt current business models in the industry. This is likely to elicit a strong response from some parts of the industry.

Process and timing

29. The two options papers will be released for public consultation following Cabinet approval. MBIE will analyse the submissions and provide me with further advice.
30. I will seek Cabinet policy decisions on the regulation of financial institutions' conduct by September 2019. I plan to introduce conduct legislation to Parliament by the end of this year.
31. I will also seek Cabinet policy decisions on insurance contract law later this year. I plan to introduce legislation to amend insurance contract law by mid-2020.
32. Further thought will need to be given to the timing of implementation. For instance, it may be appropriate to take a phased approach to implementing new conduct requirements, with aspects of the regime being extended to different types of financial institutions at different points in time.

Consultation

33. The FMA, the RBNZ, the Treasury and the Department of the Prime Minister and Cabinet (Policy Advisory Group and Greater Christchurch Group) have been consulted on this paper.

Financial implications

34. There are no financial implications from the immediate proposals in this paper (i.e. the release of two options papers). However, there will be significant funding implications for the FMA if options regarding the conduct of financial institutions are implemented.

Legislative implications

35. This paper does not propose regulatory changes at this point in time. However, most of the options discussed in the paper would require legislative changes to implement them.

Impact analysis

36. The Regulatory Quality Team at the Treasury has determined that the regulatory decisions sought in this paper are exempt from the requirement to provide an Impact Assessment as the relevant issues have been addressed in the discussion documents.
37. The Regulatory Quality Team notes that the Conduct of Financial Institutions Options Paper provides pros and cons for each option, but does not clearly link these back to the stated policy objectives. Doing so would help stakeholders and the wider public better understand the value of the options and the trade-offs between them. Nevertheless, the Options Paper should elicit informed stakeholder feedback.

Human rights

38. There are no inconsistencies between the proposals in this paper and the New Zealand Bill of Rights Act 1990 or the Human Rights Act 1993.

Gender implications

39. There are no gender implications from the proposals in this paper.

Disability perspective

40. Amending the remedies for non-disclosure will mean that individuals will no longer be able to be unduly penalised for innocent or non-material non-disclosures. In the case of health insurance this is likely to mean that those who have suffered an event leading to a disability are less likely than before to have claims unreasonably declined.

Publicity

41. I will issue a press release along with the release of the two options papers. It is likely that there will be significant media interest and public discussion of the options.

Proactive release

42. MBIE will publish a copy of this paper on its website subject to any necessary redactions consistent with the Official Information Act 1982.

Recommendations

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

1. **note** that the Options Paper on insurance contract law describes problems with the existing law and possible options for solving them, including options to address issues with:
 - 1.1. insureds' duty of disclosure and insurers' remedies for non-disclosure,
 - 1.2. insurance-specific exceptions from the prohibition on unfair contract terms,
 - 1.3. the difficulties consumers face understanding insurance policies, and
 - 1.4. a number of technical issues with insurance contract law.
2. **note** that the Options Paper on the conduct of financial institutions describes problems related to the conduct of financial institutions and possible options for solving them, including:
 - 2.1. overarching duties to govern conduct,
 - 2.2. measures to address conflicted remuneration,
 - 2.3. an obligation regarding insurance claims handling,
 - 2.4. measures to ensure financial products are suitable for customers, and
 - 2.5. a range of regulatory tools to ensure compliance.
3. **agree** to the release of the Options Paper on insurance contract law and the accompanying consumer summary,
4. **agree** to the release of the Options Paper on the conduct of financial institutions and the accompanying consumer summary,
5. **authorise** the Minister of Commerce and Consumer Affairs to make minor or technical changes to the two Options Papers and the accompanying consumer summaries prior to their release, and
6. **invite** the Minister of Commerce and Consumer Affairs to report back to Cabinet by September 2019 with the outcomes of consultation and proposed policy changes.

Authorised for lodgement

Hon Kris Faafoi

Minister of Commerce and Consumer Affairs