RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Prudential Supervision Department

18 February 2016

Financial Markets Policy
Building, Resources and Markets
Ministry of Business, Innovation & Employment
PO Box 3705
Wellington
New Zealand

To whom it may concern

Submission relating to the Options Paper released by MBIE on the 25th of November 2015 as part of its review of the Financial Advisors' Act 2008.

The Reserve Bank of New Zealand wishes to make a submission relating to the review of the Financial Advisers' Act 2008 and more specifically to the options paper released by MBIE on the 25^{h} of November 2015. Because of the Bank's prudential scope, we have decided not to use the template issued by MBIE. Our comments relate mainly to financial matters, rather than to the questions raised in the template regarding the role of advisers.

Should you have any questions regarding the content of our submission, please contact Adrian Allott at Redacted

Best regards
Redacted

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Submission relating to the Options Paper released by MBIE on the 25th of November 2015 as part of its review of the Financial Advisors' Act 2008.

The Reserve Bank of New Zealand ("the Bank") commends the Ministry of Business, Innovation and Employment ("MBIE") for the initiative MBIE is taking in its review of the way in which financial advice is provided in New Zealand. It is appropriate that MBIE, as the policy-making agency in the domain of market conduct, and the Financial Markets Authority ("FMA"), as the regulator and supervisor of the same domain, lead this work.

Nonetheless, the Bank wishes to provide input to the review in so far as it relates to our area of regulatory interest. There are aspects of the provision of advice which impact on the Bank's prudential supervision objectives, as stated in the Insurance (Prudential Supervision) Act 2010 (IPSA), section 3(1):

a) to promote the maintenance of a sound and efficient insurance sector; and
b) to promote public confidence in the insurance sector.[1]

Ultimately, the Bank believes that the objectives of IPSA will be furthered through either self-regulation of distribution channels by the industry, or regulation by agencies of Government. Should the industry fail to adequately self-regulate, the Government may need to step in.

Commission levels

A number of economic activities in New Zealand are remunerated by commission, and commission is an appropriate way of incentivising sales provided that the interests of the client are considered, and the commission structures and levels do not threaten the viability of the companies offering them.

There has been anecdotal reference over a long period of time to levels of commission payable on sale of individual life insurance policies in New Zealand being very high compared with similar markets overseas. Whilst this contention stands to be confirmed by rigorous analysis[2], it is nevertheless possible to comment on the impact of high commission rates on the objectives of IPSA.

1. High commission rates may result in higher premium rates as insurers pass on costs. This, in turn, lowers the proportion of the premium returned as claims, and erodes the efficiency of the insurance sector in providing the general public with risk reduction services.
2. Alternatively, insurers may choose to absorb the costs of high commission rates, reducing their profitability and eroding their solvency position.

[1] Note that the Bank interprets this objective as relating to the financial stability of the insurance sector
[2] More rigorous analysis has been performed recently in Australia, contained in the FSI, Murray & Trowbridge reports. This analysis indicated that commission levels in the Australian market are high by international standards. It is widely acknowledged that levels of commission in New Zealand are higher again than those prevalent in Australia, and this relativity is of concern to the Bank.

3. Under the RBNZ solvency standards, capital may effectively be required to be set aside against the risk that policies will terminate early and that commission costs already incurred will not be recovered. High commission rates increase the amount of such capital that life insurers must hold, decreasing their solvency margins and ratios, and making the insurance sector less sound than it otherwise may be.
4. High commission rates present an elevated barrier to new entrants and hence to the efficiency of the sector. This is because new entrants must finance commissions from external sources, rather than by using the profit released from in-force business. Where financing is unavailable they may need to artificially constrain their sales activity.

The Bank is supportive of measures to lower commission levels by improving the functioning of the market.

Commission structures

Of equal concern to the overall level of commission payable are the structures that are used to deliver it.

Front-loading

Whilst creation of value for customers and shareholders often depends on the policy remaining in-force over the long term, high up-front commissions mean that advisers can extract most of the value attributable to them within the first year or two of the contract's term. Value for advisers as a group is therefore maximised by cancelling contracts once the initial commissions are vested and replacing them with new policies ("churning" the portfolio). The impact of churning on the IPSA objectives can be characterised as follows:

1. Insurer balance sheets will gradually be weakened and the sector become less sound if current levels of churn are not adequately priced into products (i.e. if policies do not stay in-force long enough to return a profit to insurers)
2. The sector is less efficient as premium rates are higher than they would be in the absence of churn, making insurance less affordable and potentially leading to under-insurance.
3. Efficiency is also adversely affected by the potential loss of cover of pre-existing conditions on cancellation and re-issue.

The Bank supports measures to reduce the degree of churning, such as

1. Better alignment of the timing of advisor commissions, policyholder benefits and shareholder profits, to ensure all parties have a strong interest in keeping policies in-force,
2. Incentives or requirements for advisors to provide on-going client service, and
3. Mechanisms through which customers can seek redress for inappropriate sales.

Volume bonuses

A particular concern relates to remuneration that is linked to selling specific volumes of life insurance business for a single insurer. These volume bonuses may be paid in cash, as "shadow shares", as luxury items or as travel incentives.

Such remuneration elements are likely to encourage the sale of that insurer's products over products from other insurers that may better meet the needs of the customer or which may have a lower price.

The Bank would support excluding volume-based payments from insurers to advisors.[3]

Soft-dollar compensation

Another structural element that presents challenges is the payment of benefits-in-kind (or "soft-dollars"), such as shadow shares or travel incentives. These are popular with insurers because such benefits can have a greater psychological impact than cash commissions in motivating sales activity.

Sometimes these benefits are offered with opaque qualification criteria, or to restricted groups of advisers. The structure of some soft-dollar compensation may also adversely impact on the quality of advice provided to the client.

The Bank would support moves to raise the sector's efficiency by helping the market to improve the quality of soft dollar remuneration. Such moves could include making sure that any benefits are available to all advisors, disclosing to customers the cost of such benefits at point-of-sale or structuring the compensation so that it is better-aligned with the provision of service to customers.

Quality of advice

Mis-selling has imposed significant costs on insurers in some jurisdictions, with obvious implications for solvency. It is conceivable that mis-selling could eventually impose similar burdens on New Zealand insurers as courts begin to recognise insurer and advisor liabilities to customers.

The Bank is supportive of moves to identify, reduce and remove bias from insurance advice, as well as to improve the quality and suitability of advice. We note that MBIE's options paper contains a number of proposals in this area.

Thank you for this opportunity to state our view. We would be happy to meet with you and discuss these matters in more detail.

Yours sincerely
Redacted

Peter Brady
Manager, Insurance Oversight

[3] It may still be possible for ***brokers*** (rather than insurers) to offer volume bonuses to their associated advisors, provided that volume was measured across all sales, not those for a specific insurer.