MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

COVERSHEET

Minister	Hon Kris Faafoi	**Portfolio**	Commerce and Consumer Affairs
Title of Cabinet paper	**Conduct of Financial Institutions: Introduction of a New Conduct Regime**	**Date to be published**	25 September 2019

List of documents that have been proactively released		
Date	**Title**	**Author**
11 September 2019	*Conduct of Financial Institutions: Introduction of a New Conduct Regime*	*Office of the Minister of Commerce and Consumer Affairs*
11 September 2019	*DEV-19-MIN-0237*	*Cabinet Economic Development Committee*
11 September 2019	*Regulatory Impact Statement: Regulatory regime to govern the conduct of financial institutions*	*Ministry of Business, Innovation and Employment*

Information redacted **YES**

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Reasons for withholding information:

- Confidential advice to Government

In Confidence

Office of the Minister of Commerce and Consumer Affairs

Chair, Cabinet Economic Development Committee

CONDUCT OF FINANCIAL INSTITUTIONS: INTRODUCTION OF A NEW CONDUCT REGIME

Proposal

1. This paper seeks agreement to introduce a new regime governing the conduct of financial institutions, and in particular banks and insurers. The proposals are to:

   1.1. create a licensing regime for banks, insurers and non-bank deposit takers (NBDTs) in respect of their general conduct, including aspects of how they design and offer sales incentives;

   1.2. make licensed entities accountable for non-advised sales by intermediaries; and

   1.3. prohibit sales incentives based on volume or value targets.

2. These proposals are intended to form the basis of a broad conduct regime that could be expanded over time in further legislation, with further obligations on regulated entities or expansion to further entities if appropriate.

3. Confidential advice to Government

Executive Summary

4. Financial institutions, and the products and services they provide, are an essential part of a well-functioning society. Financial products and services are typically complex and often high-value, and there is often an imbalance of power between financial institutions and the customers they serve. This creates a particular and acute risk of harm to customers. When things go wrong with financial products or services, it can be catastrophic at the individual level and cause significant harm at the broader societal and economic level.

5. Recent reviews have identified that banks and life insurers lack focus on good customer outcomes, and have insufficient systems and controls to identify, manage and remedy conduct issues. This creates real risk of misconduct and I have heard New Zealand examples of actual misconduct occurring (for example, customers being sold insurance products that they are ineligible to ever claim on).

6. Accordingly, I am proposing a new conduct regime for financial institutions to address the real risk of harm to customers. I intend to introduce legislation for the new conduct regime to the House by the end of 2019.

Licensing regime

7. I propose to introduce a licensing regime for banks, insurers and NBDTs in relation to their general conduct.

8. The licensing regime would require licensed entities to meet a high-level fair treatment standard, for example, to pay due regard to the needs and interests of customers and treat them fairly. Licensed entities would be required to have and implement effective policies, processes, systems and controls to meet the fairness standard.

9. Licensed entities would also be subject to obligations in relation to remuneration and sales incentives, and how they manage the risks those incentives create.

10. The FMA would have powers to monitor and enforce licensing obligations on an ongoing basis. Strong civil liability and pecuniary penalties would apply for contravention of obligations.

Mechanisms to address the conduct of intermediaries

11. I propose that licensed entities be accountable for sales made by intermediaries who are not financial advice providers (for example, car dealers and retailers selling add-on finance). This will ensure that the obligations on banks, insurers and NBDTs flow down the chain of supply and result in better outcomes for customers that deal with intermediaries.

Prohibition of sales incentives based on volume or value targets

12. I propose to prohibit incentives based on volume or value targets e.g. soft commissions such as overseas trips, bonuses for selling a certain number of financial products, leader boards, performance management based on volume of sales etc. These incentives increase the risk of mis-selling because they create an increasingly strong incentive to sell and therefore encourage the person making the sale to prioritise their own interests over that of the customer.

13. Civil liability, including pecuniary penalties and compensation for particular customers, would be available for contravention of the prohibition.

Confidential advice to Government

Background

15. There have been several recent reviews examining the conduct of financial institutions, including:

    15.1. The 2018 FMA and Reserve Bank of New Zealand (RBNZ) reviews of banks and life insurers.

15.2. A 2018 Ministry of Business, Innovation and Employment (MBIE) issues paper looking at insurance contract law and the conduct of insurers.

15.3. The 2017 review by the International Monetary Fund of New Zealand's financial sector as part of its Financial Sector Assessment Programme.

15.4. The 2018 Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (ARC). Some of the issues identified in Australia are similar to those identified in New Zealand.

16. These reviews have identified extensive weaknesses in the conduct and culture of institutions in New Zealand's financial sector, particularly in respect of governance and management of conduct risks and focus on outcomes for customers. The reviews also highlighted a gap in our regulatory settings in that there is currently no explicit legislative mandate for the regulation of the general conduct of financial institutions.

17. We need to fill these regulatory gaps and address the risk of harm that they create. Taking immediate action to improve our ability to prevent and penalise poor conduct will lead to better outcomes for New Zealanders than initiating a further inquiry into the sector.

18. In February 2019, the Minister of Finance and I announced the Government's intention to address the findings of the FMA and RBNZ reviews of banks and life insurers [CAB-19-MIN-0011]. We committed to introducing legislation to the House this year to address the issues.

19. On 10 April 2019, the Cabinet Economic Development Committee approved the release of an options paper entitled *Conduct of Financial Institutions* [DEV-19-MIN-0082]. The paper sought feedback on the conduct and culture problems that had been identified in the FMA/RBNZ reports, and proposed solutions to address these problems.

Why regulatory intervention is required

Financial products, services and institutions create particular risks

20. Financial products, services and financial institutions themselves have characteristics that create particular and acute risks of harm to customers. Because of these risks, there is a strong case for regulatory intervention in the sector to minimise the potential harm to customers.

21. These characteristics include:

21.1. Financial products and services are complex, high value, often long-term and can be difficult to replace or switch between. Information asymmetries are often very difficult given the particularly complex nature of financial products and services.

21.2. There is an inherent imbalance of power between financial institutions and customers. As the ARC observed, financial institutions in Australia acted the way they did “because they could” due to the marked imbalance in knowledge and power.

21.3. Many financial decisions are one-off with little ability for the customer to learn from mistakes. The impact of poor financial decision can range from minor to catastrophic e.g. loss of wealth accumulated over a lifetime or loss of insurance cover that impacts on entire family.

Evidence of risk of harm, and actual harm, to customers

22. The risk of harm caused by the characteristics above has been highlighted in recent work examining the conduct of financial institutions in New Zealand. The FMA/RBNZ’s reviews of banks and life insurers found evidence of extensive weaknesses across these institutions’ systems and controls to identify, manage and remediate conduct issues and risks, and a lack of focus on good customer outcomes. This meant, for example, products and services not being suited to customers’ needs on an ongoing basis and inadequate systems for handling complaints and claims.

23. These system and control weaknesses create real risk of misconduct, and in some cases we have evidence of actual misconduct occurring. I have heard New Zealand examples of insurers selling policies to thousands of customers who were ineligible for cover (i.e. policies they could never claim on) or being charged incorrectly, resulting in hundreds of thousands of dollars of damage. In the banking sector, high-value products like insurance products or credit cards are often cross-sold or incentivised through commissions when they may be unsuitable or unnecessary for customers.

24. The FMA/RBNZ reviews and the ARC also identified that conflicted remuneration and incentives are one of the biggest issues driving poor outcomes for customers in the financial sector. As the ARC found in relation to individual sales incentives: “*In almost every case, the conduct in issue was driven not only by the relevant entity’s pursuit of profit but also by individuals’ pursuit of gain.”*

Further regulation is required

25. In light of these issues, and despite recent improvements and ongoing work (e.g. the new financial advice regime, and changes to the consumer credit contracts regime), I consider that further regulation is required. I also consider that non-regulatory options alone (such as industry developed codes of conduct) are insufficient.

Conduct licence for banks, insurers and non-bank deposit takers

26. I propose to require banks, insurers and NBDTs to be licensed by the FMA under Part 6 of the Financial Markets Conduct Act 2013 (FMC Act) in respect of their general conduct. The inclusion of NBDTs reflects the fact that many NBDTs offer similar products and services to banks and that Cabinet has made in-principle decisions to remove the distinction between banks and NBDTs in prudential regulation [DEV-19-MIN-0161]. It makes sense to reflect this position in conduct regulation.

27. At a high-level, the proposed licensing regime is intended to set a standard of conduct and culture where licensed entities must pay due regard to customers' needs and interests and treat customers fairly. Banks, insurers and NBDTs would be required to ensure that their business models and strategies take customers' interests into account and that appropriate systems and controls monitor whether customers' needs are being met.

28. Fair treatment means that:

    28.1. Customers have confidence that they are dealing with institutions that place the fair treatment of customers at the heart of their business.

    28.2. Customers receive clear, fair and not misleading information and are kept appropriately informed at every point they interact with the institution, including during any claim or complaint.

    28.3. Institutions design and sell, and customers ultimately receive, products and services that meet the customers' needs.

    28.4. Customers do not face unreasonable pressure to retain or change products, switch provider, submit a claim, make a complaint, or make other product or service decisions or changes – but neither are they unreasonably prevented from doing so if they wish to.

    28.5. Customers are provided with products and associated services of an acceptable standard and which perform or operate as institutions have led them to expect.

    28.6. Institutions establish, implement and maintain effective and transparent complaint-handling systems and customers are treated fairly in interactions with such systems.

29. Whereas other financial regulation governs specific products and services (e.g. the new financial advice regime), this proposed conduct licensing regime would apply in respect of all aspects of the business that relate to retail customers, including all products and services offered by banks, insurers and NBDTs to retail customers, at all points of the life-cycle of the products and services. This includes (but is not limited to) credit, insurance, KiwiSaver, and associated services (e.g. complaints and claims handling, information provision). Regulations could further determine the scope of financial products and services covered by the regime. The concept of "retail customer" will be broadly consistent with similar concepts in the FMC Act. Broadly speaking, this covers general consumers and small businesses with assets or turnover of up to $5 million in a financial year.

30. The licensing regime will allow also for a proportionate approach to be taken in respect of different entities, depending on the risk of harm e.g. life insurers vs general or travel insurers, banks vs NBDTs. This can be done through the licensing application process, conditions of licences and an ongoing, risk-based approach to monitoring.

Licensing regime would include a high-level fair treatment standard

31. The licensing regime would include a high-level fair treatment standard. Further, more detailed obligations would be set out in the Act, regulations and conditions of licences as appropriate to achieve the standard. Regulatory enforcement tools would also support the achievement of this conduct standard.

32. The high-level fair treatment standard would be set out in the FMC Act. The precise boundaries of the standard would be developed through the drafting process. The standard itself may not provide sufficient clarity to be directly enforceable. However, I propose that in order to hold a licence, banks, insurers and NBDTs would have to have policies, processes, systems or controls outlining what they are doing to meet the high-level fair treatment standard. The regime would have the flexibility to be able to prescribe in the FMC Act, regulations or conditions (or a combination thereof) what these policies, processes, systems or controls would have to contain. These requirements would be directly enforceable.

33. The standard would also create the framework for further obligations, whether in the FMC Act, regulations or licence conditions. These could include obligations regarding communication with customers, claims handling etc.

Licensing regime would include remuneration and incentives obligations

34. As part of the licensing regime, banks, insurers and NBDTs would be subject to an obligation regarding their remuneration and sales incentives.

35. It is intended that this obligation would require banks, insurers and NBDTs to consider the risks and potential harms that their incentives create, and then design and offer their incentives in a way that minimises the risk and is consistent with the overarching fair treatment standard. This refers to remuneration and incentives in the broadest sense e.g. commissions, soft commissions, bonuses, leader boards, performance management etc. In practice, for example, this obligation would require a life insurer to review commission structures provided to life insurance brokers and reduce levels of commissions if there was found to be a risk that these are leading to consumers being switched unnecessarily.

36. This obligation is intended to address the risk of sales incentives structures leading to sales being prioritised over good customer outcomes. As noted above, conflicted remuneration and incentives have been identified as one of the biggest issues driving poor outcomes for customers in the financial sector.

37. This obligation could be achieved through a combination of another high-level conduct standard in the Act (i.e. additional to, or a subset of, the fair treatment standard), coupled with requirements for specific policies, processes, systems and controls, like those described above.

38. The intention of this obligation is not to ban commissions, but to minimise the risks of harm to customers that arise from particular remuneration and incentive structures.

Enforcement

39. The licensing regime would provide the FMA with a full range of monitoring, supervision and enforcement tools to ensure entities' compliance with their obligations. These include reporting obligations on entities, the ability for the FMA to give a censure, require an action plan, give a direction, and to suspend, or vary, conditions of a licence. The FMA may suspend or cancel a licence in certain circumstances and failure to comply with an FMA order without reasonable excuse is a criminal offence and subject upon conviction to a fine of $300,000. The licensing regime would also include the ability for the FMA to review licensed entities' systems and controls at any point and to require amendments.

40. Civil liability, including pecuniary penalties and compensation for particular customers, may apply for serious or material breaches of systems and controls requirements, including as they relate to remuneration and incentives design. I propose that pecuniary penalties not exceed the greatest of:

   40.1. the consideration for any relevant transaction;

   40.2. three times the amount of the gain made or the loss avoided; and

   40.3. $1 million for an individual and $5 million for bodies corporate.

41. These maximum penalty amounts are the same as those already existing in the FMC Act. These are appropriate given the nature and large size of the entities being regulated, the potential for harm to customers arising from contravention of the obligations, and the fact that these proposed system and controls obligations are intended to apply to the entirety of a licensed entity's business operations, rather than at a particular point in time.

42. Licensed entities will also be required to have in place effective methods for monitoring compliance with their licence obligations, including the proposed system and controls requirements, and to report any material contraventions of licence obligations or changes in circumstances. Contravention of these monitoring and reporting obligations may give rise to civil liability, including pecuniary penalties of up to $600,000.

43. Supplementary obligations may also be necessary to ensure the regime is effective. These may include further specific requirements around reporting, and review and improvements to systems and controls.

Implications, costs and risks of licensing

44. The proposal to license banks, insurers and NBDTs does raise some costs and risks. For example:

   44.1. Not licensing or directly regulating intermediaries or other lenders who are not banks or NBDTs could leave some outstanding risk of harm to customers. However, these entities are not unregulated – consumer credit and financial advice regulation, for example, still applies. Moreover, the majority of the conduct risks and poor outcomes for customers that have been identified to date arise in and originate from banks and insurers. Licensing these entities is therefore expected to address the majority of the risk. Consideration can also be given to whether the scope of the conduct regime, including through licensing, should be expanded in the future.

44.2. Licensing can impose considerable costs on both the regulated entities and the regulator, depending on the licence obligations. These costs may be passed on to customers. In the worst case scenario, additional regulatory costs may push smaller players out of the market (e.g. small credit unions).

44.3. Licensing can create barriers to entry for new players. This could have an impact on future opportunities for enhanced competition and the structure of the market.

44.4. Licensing will also create a 'dual licence' regime, with banks and insurers required to obtain a prudential registration or licence from the RBNZ and a conduct licence from the FMA. This will require these two regulators to coordinate their activities in respect of the same institutions. I note, however, that this already occurs to an extent with existing FMC Act licences in New Zealand and is similar to the situation in other jurisdictions such as the United Kingdom and Australia.

Interaction with existing regulation

45. I note that the proposed conduct regime would create some potential overlap with existing regulation e.g. consumer credit regulation under the Credit Contracts and Consumer Finance Act 2003 and the financial advice regime. In a general sense, those pieces of legislation regulate specific interactions, services or products (e.g. lending and financial advice situations). The new conduct regime would govern licensed entities' entire business conduct and culture as it relates to retail customers. Coordination between the FMA and the regulators responsible for enforcing these other regimes (e.g. the Commerce Commission) will be necessary.

46. The proposed requirement for entities to have systems and controls allows a coordinated and flexible approach to be taken to different regulatory requirements arising under different regimes. These systems and controls could set out how the compliance with different obligations fit together in the circumstances of a particular bank, insurer or NBDT. Officials will continue to consider how overlaps are managed as they develop the detail of the regime.

Implementation of licensing regime

47. Further consideration will be given to how and when to implement the new conduct licensing regime most efficiently, having regard to the readiness of the regulator (including licensing processes), the parts of the industry presenting the greatest risks, and the readiness of the industry to comply with the new obligations. Decisions on implementation will be sought at the same time as approval to introduce the Bill implementing the new regime.

48. A phased approach to implementation may be appropriate in some instances. For example, I propose that banks and insurers would be licensed first, followed by

NBDTs at a later date. This is because while potential risks exist with NBDTs given the nature of the products and services they offer, there is not the same evidence of current conduct risk and actual customer harm occurring, as there is with banks and insurers. The same urgency to regulate therefore does not exist. Licensing of NBDTs could therefore come into force at a later stage and allow the FMA to initially focus its resources on the institutions of most concern.

Mechanisms to address the conduct of intermediaries

Licensed entities to be accountable for sales made by intermediaries who are not subject to new financial advice regime

49. I propose that licensed banks, insurers and NBDTs be accountable for sales made by their intermediaries who are not financial advice providers. Examples of non-adviser intermediaries include car dealers and retailers selling add-on finance and insurance, and travel agents or airlines selling travel insurance.

50. I consider that it is reasonable and appropriate for banks, insurers and NBDTs to take responsibility for the outcomes for their end customers, especially where no independent intermediary is advising the customer. As the product providers, banks, insurers and NBDTs should take responsibility for the actions of the intermediaries distributing their products and manage this responsibility through some form of agency agreement.

51. I propose that the licensed entity would be liable for any breaches of the conduct obligations made by the intermediary. This approach will ensure that the obligations on banks, insurers and NBDTs flow down the chain of supply and improve the front-line interaction with the customer.

52. I envisage that the bank, insurer or NBDT would require intermediaries to comply with any relevant obligations that the licensed entity is subject to – e.g. the systems and controls that it has in place to comply with the high-level fair treatment standard, and any requirements relating to information provision and sales processes.

Licensed entities <u>not</u> to be directly accountable for the advice provided by intermediaries that are subject to financial advice regime

53. At this point in time, I do not propose that licensed entities be directly accountable for the advice provided by those intermediaries who are subject to the new financial advice regime.

54. The recently passed Financial Services Legislation Amendment Act 2019 (FSLAA) requires all financial advisers to be engaged by a financial advice provider, and imposes a range of conduct obligations on financial advisers. Some of these obligations are similar to what is proposed in the new conduct regime. For example, financial advisers now have a duty to adhere to a code of conduct, and have a duty to prioritise the client’s interests.

55. The new FSLAA regime is untested as yet but is expected to be effective at regulating the interaction in an advised sale context. It is worth waiting to see how effective the FSLAA regime is before moving to make banks, insurers and NBDTs

more directly accountable for sales through intermediaries that are already subject to some regulation.

56. However, I consider that this does not absolve the bank, insurer or NBDT of responsibility for its customers' outcomes. Regardless of the distribution channel, banks, insurers and NBDTs should take action to ensure the objectives and needs of their customers are met. This may include: providing financial advisers with training about their products, setting expectations of good conduct, providing information that needs to be passed on to customers and taking action where they become aware of activity that might not be in the customer's interests. Taking action might include reiterating expectations of good conduct, providing further training, restructuring remuneration/incentives to avoid perverse outcomes, reporting the adviser to the FMA or ultimately ceasing to use the adviser to distribute their products.

57. The regime that I am proposing would also enable regulations or licence conditions to specify steps that the licensed entity must take when dealing with intermediaries of any kind (such as arrangements dealing with oversight of the intermediary and responsibility for the end customer).

58. I also consider that the new conduct regime should preserve the possibility of further licence conditions on financial advice providers that align with the new conduct obligations. This would future-proof the regime to address any problems that might arise if financial advice providers do not conduct themselves in a way that is consistent with the high-level conduct standard expected of banks, insurers and NBDTs.

Prohibition of sales incentives based on volume or value targets

59. Some remuneration and incentive structures can exacerbate the conflicts of interest and increase the risks of mis-selling. This is particularly true of incentives that include a target-based component. Targets create an increasingly strong incentive to sell and therefore encourage the person making the sale to prioritise their own interests over that of the customer. Target-based incentives can include monetary rewards (e.g. variable pay) and soft commissions (e.g. overseas trips) that are only provided once the seller has achieved a certain value of sales or number of sales (volume). An example of a volume or value based incentive could be a bonus of $5,000 for being in the top 20 per cent of sellers or for selling $5 million worth of insurance policies, while a soft commission could be a paid holiday to Queenstown for selling a certain number of policies.

60. To address this problem, I propose to regulate incentives based on volume and value, and in particular, to prohibit incentives based on targets linked to sales value or volume, including soft commissions.

61. This proposal would apply to banks, insurers, NBDTs and their intermediaries, covering incentives both to internal staff and external intermediaries, and cover monetary and non-monetary incentives of any kind. This prohibition covers intermediaries because I have heard examples of product providers paying intermediary dealer groups who then offer incentives to advisers in the form of overseas holidays.

62. The intention of this obligation is not to ban all commissions, but to remove particular incentive structures based on volume or value targets that create particularly perverse incentives to sell.

63. There is a risk with a specific and narrow ban that some institutions may try to restructure their incentives in a way that avoids the scope or effect of the ban. To mitigate this risk, the restrictions could be implemented through an appropriately framed regulation-making power, and licensing conditions. This would make the restrictions more flexible and future-proofed. Because of the difficulty of accurately framing the restrictions, I also propose that scope be preserved such that some volume- or value-based incentives might be banned outright, and others are regulated or allowed, subject to restrictions.

64. Civil liability, including pecuniary penalties and compensation for particular customers, may apply for contravention of these obligations. I propose that for licensed entities, pecuniary penalties of up to $1 million for an individual and $5 million for bodies corporate would be appropriate. This would align with penalty levels for breach of systems and control requirement under their licence, which would likely include remuneration and incentive controls. For non-licensed entities, pecuniary penalties of up to $200,000 for an individual and $600,000 for bodies corporate would be appropriate.

Other options to be considered further

65. In its options paper published in April, MBIE consulted on a range of options to address conduct of financial institutions. A number of these options are not being progressed at this time as they are not critical to achieving a core regime for regulating the conduct of financial institutions. These include product intervention powers and product design and distribution obligations.

66. One option, however, is likely to be progressed in the shorter term. This involves mechanisms to increase accountability for senior executives (e.g. managers and directors) of financial institutions in respect of the conduct of the institution. The Minister of Finance has announced that the Government is also considering increasing the responsibilities and accountabilities of senior executives in respect of their prudential obligations, as part of Phase 2 of the Reserve Bank Act Review. Officials will work together so that any proposals on executive accountability are coordinated across the conduct and prudential spaces.

Consultation

67. The following departments were consulted on this paper: the Treasury, Reserve Bank of New Zealand, Financial Markets Authority, Department of the Prime Minister and Cabinet, Commerce Commission and Ministry of Justice. The Parliamentary Counsel Office has also been consulted on the legislative implications of the policy proposals.

68. The high-level proposals in this paper were subject to a public discussion paper, on which 85 submissions were received. Submitters included individual consumers, banks, life insurers, general and health insurers, managed investment schemes, financial advisers, industry associations, law firms and dispute resolution schemes.

Submitters' views on these proposals are briefly summarised in the regulatory impact statement accompanying this paper.

Confidential advice to Government

77. Confidential advice to Government [redacted]

Financial implications

New conduct regime

78. Implementation of these options will have significant funding and resourcing implications for the FMA due to the new remit of licensing, monitoring and enforcing the new conduct obligations, including through litigation activity. Licensing costs would be directly recoverable through fees and wider monitoring costs may be indirectly recoverable through industry levies.

79. I propose to come back to Cabinet to seek the necessary funding for the conduct proposals in this paper (including consequent increases in litigation activity) once these costs, and the timing of implementation, are clearer

Confidential advice to Government [redacted]

Legislative Implications

81. The policy decisions in this paper will require legislative change to be progressed through a bill to amend the Financial Markets Conduct Act 2013.

82. The amendments will be binding on the Crown, consistent with the primary legislation.

83. As the Bill is not currently in the 2019 Legislation Programme, I propose to include the Bill to the Legislation Programme with a category 4 priority (to be referred to a Select Committee in the year). I intend to introduce legislation to the House by the end of 2019.

Impact Analysis

84. MBIE's Regulatory Impact Analysis Review Panel has reviewed the attached Regulatory Impact Statement prepared by MBIE. The Panel considers that the information and analysis summarised in the Regulatory Impact Statement meets the criteria necessary for Ministers to make informed decisions on the proposals in this paper.

Human Rights

85. The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Gender Implications

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

Disability Perspective

87. This paper is consistent with the New Zealand Disability Strategy 2016-2026 and the Disability Action Plan 2014-2018.

Publicity

88. I intend to publicly announce decisions on this paper and issue a press release alongside this announcement, in the week following Cabinet approval.

Proactive Release

89. Following public announcements on policy decisions, I intend to release this paper proactively, subject to redaction as appropriate consistent with the Official Information Act 1982.

Recommendations

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

1. note that on 10 April 2019, the Cabinet Economic Development Committee agreed to the release of the options paper, *Conduct of Financial Institutions* [DEV-19-MIN-0082];

2. note that various reviews have found weaknesses in the conduct and culture of financial institutions, and in particular banks and life insurers in respect of their governance and management of conduct risks and focus on outcomes for customers;

3. note that there is currently no explicit legislative mandate for the regulation of the general conduct of financial institutions;

4. agree that banks, insurers and non-bank deposit takers will be required to be licensed under Part 6 of the Financial Markets Conduct Act 2013 by the Financial Markets Authority in respect of their conduct in relation to retail customers;

5. agree that regulations can determine the scope of financial products and services covered by the regime;

6. agree to a licensing regime that – through obligations in the Act, regulations and licence conditions – will require that banks, insurers and non-bank deposit takers meet a high-level standard, for instance, to pay due regard to the needs and interests of customers and treat them fairly;

7. note that consideration will be given to how to implement the new conduct obligations and licensing regime as efficiently as possible, including transition periods, how licences are granted and sequencing the application of the regime to different types of entities;

8. agree that banks, insurers and non-bank deposit takers will be required to have and implement effective policies, processes, systems and controls to meet the high-level fair treatment standard;

9. agree that the Financial Markets Authority as regulator would have the ability to review licensed entities' policies, processes, systems and controls at any point and to require amendments;

10. agree that in respect of the obligations under the new regime, banks, insurers and non-bank deposit takers will be accountable for the activities of their intermediaries that are not financial advice providers;

11. agree that the regime will allow for regulations or licence conditions to subsequently be made to create oversight and responsibility arrangements in relation to intermediaries that are financial advice providers;

12. agree that banks, insurers and non-bank deposit takers will be subject to obligations regarding how they design their remuneration and sales incentives and how they manage the risks those incentives create;

13. note that the Financial Markets Authority's powers under Parts 6 and 8 of the Financial Markets Conduct Act 2013 in relation to licensed market services would apply in relation to the above obligations (for example, action plans, and directions);

14. agree that the regime will provide for any supplementary matters to make it effective (such as whistle-blowing protections and further requirements on licensed entities, e.g. specific reporting requirements (including reporting on specified material contraventions) and requirements to review their processes);

15. agree that material contravention of the obligations relating to policies, processes, systems and controls may give rise to civil liability, including compensation for particular customers and pecuniary penalties of up to the greatest of:

    15.1. the consideration for any relevant transaction;

    15.2. three times the amount of the gain made or the loss avoided; and

    15.3. $1,000,000 for an individual and $5,000,000 for bodies corporate;

16. agree to regulate sales incentives based on volume or value targets (this regulation would apply to banks, insurers, non-bank deposit takers and the intermediaries of these institutions creating these types of incentives);

17. agree that contravention of requirements or prohibitions imposed by recommendation 16 above may give rise to civil liability, including pecuniary penalties of:

    17.1. for banks, insurers and non-bank deposit takers licensed under the new conduct regime, up to $1,000,000 for an individual and $5,000,000 for bodies corporate;

    17.2. for all other entities, up to $200,000 for an individual and $600,000 for bodies corporate;

18. approve the inclusion of a Bill giving effect to these proposals in the 2019 Legislation Programme, with a Category 4 priority (to be referred to a Select Committee in the year);

19. invite the Minister of Commerce and Consumer Affairs to issue instructions to the Parliamentary Counsel Office to give effect to the recommendations above;

20. authorise the Minister of Commerce and Consumer Affairs to make decisions consistent with the proposals in these recommendations on any minor or technical matters that may arise during the drafting process;

21. note that implementation of the above proposals will have fiscal implications and will likely require additional funding for the Financial Markets Authority, and that I will come back to Cabinet to seek decisions on funding at a later stage once the costs of the new regime are clearer;

Confidential advice to Government

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Confidential advice to Government

Confidential advice to Government

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Authorised for lodgement

Hon Kris Faafoi

Minister of Commerce and Consumer Affairs