To: Ministry of Business, Innovation and Employment

On: Conduct of Financial Institutions Options Paper

June 2019

INTRODUCTION

This submission is from full service law firm Chapman Tripp. We have offices in Auckland, Wellington and Christchurch.

Our contacts for the purposes of this submission are:

MARK REESE – PARTNER
T: +64 4 498 4933
M: +64 27 231 1925
E: mark.reese@chapmantripp.com

ALAN LESTER – SPECIAL COUNSEL
T: +64 4 498 4959
M: +64 27 285 0160
E: alan.lester@chapmantripp.com

ROSS PENNINGTON – PARTNER
T: +64 9 357 9030
M: +64 27 442 2161
E: ross.pennington@chapmantripp.com

PENNY SHEERIN – PARTNER
T: +64 9 358 9817
M: +64 27 556 6516
E: penny.sheerin@chapmantripp.com

JOHN KNIGHT - PARTNER
T: +64 4 498 4947
M: +64 27 224 9819
E: john.knight@chapmantripp.com

TIM WILLIAMS – PARTNER
T: +64 9 358 9840
M: +64 27 243 1629
E: tim.williams@chapmantripp.com

ROGER WALLIS – PARTNER
T: +64 9 357 9077
M: +64 27 478 3192
E: roger.wallis@chapmantripp.com

BRADLEY KIDD – PARTNER
T: +64 4 498 6356
M: +64 27 224 1271
E: bradley.kidd@chapmantripp.com

EMMA SUTCLIFFE – PARTNER
T: +64 4 498 6323
M: +64 27 294 9114
E: emma.sutcliffe@chapmantripp.com

CATHRYN BARBER – PARTNER
T: +64 9 357 9025
M: +64 27 447 9163
E: cathryn.barber@chapmantripp.com

Introduction

1 Thank you for the opportunity to submit on the Ministry of Business, Innovation and Employment (***MBIE***) April 2019 Conduct of Financial Institutions Options Paper (***Options Paper***). The proposals are of direct interest to us as legal practitioners and to our clients.

2 Our submission mirrors the structure of the Options Paper. We have responded only to those questions where we have a view and have occasionally covered more than one question in an answer.

3 Our submission does not purport to represent the views of our clients.

Summary

4 Designing a regulatory regime that seeks to improve conduct and culture across the financial sector is a difficult and complex exercise which will need to have regard to existing regulation, particularly in the financial advisory, securities and lending industries.

5 The proposed reforms need to be proportionate to the issues that have been identified. Over-reach could stifle competition by setting up unreasonable barriers to entry, and/or create a highly conservative and risk-averse culture, and/or unduly interfere with the industry's ability to innovate to meet current and future market demands.

6 Regard also needs to be given to the fact that customers might want the freedom to make their own choices along the risk/reward spectrum and place a value on choice - accepting that investment decisions can result in loss or failure, rather than losing opportunities to an abundance of caution.

7 As the Options Paper notes in a number of places, some of the proposals carry potentially significant cost implications. It is important that these are fully assessed so that desirable customer outcomes are not rendered uneconomic. To this end, we consider it essential that there is a proper cost benefit analysis in the second stage of the review to inform decision-making.

Options for Overarching duties – (Questions 1- 3)

8 Consideration needs to be given to what particular "harm" each overarching duty is seeking to address, what the duty involves, and how it should be interpreted. Without stakeholders having a clear understanding of these elements, we question whether the desired effect of "delivering good outcomes for all customers" will be achieved.

9 This is particularly the case if the regime imposes personal liability for failure to satisfy these duties. Without clarity, directors and senior managers are likely to take an overly conservative approach to compliance, leading to a real risk that innovation and dynamism will be suffocated in the financial sector. Clearly, such an unintended consequence should be avoided.

10 The development of the overarching duties should also have regard to the conduct and customer focussed duties in adjoining regulatory regimes. Particularly relevant are the duties of lenders under the responsible lending principles of the Credit Contracts and Consumer Finance Act 2003 (***CCCFA***) and the duties of financial advisers under the Financial Advisers Act 2008 (***FAA***) and its successor, the Financial Services Legislation Amendment Act 2019 (***FSLAA***).

11 Elements of the proposed duties around the information needs of customers, and the need to communicate in a way which is clear and timely have significant overlap with the disclosure regime under the Financial Markets Conduct Act 2013 (***FMCA***) (including the fair dealing provisions in Part 2 of the FMCA) and with the disclosure changes being proposed as part of the current review of insurance contract law.

12 An outcome which has conflicting or inconsistent duties across the various regimes would undermine the authority of each regime, create redundancy where there are points of difference, and impose unnecessary costs.

13 This will apply equally to any guidance or codes of practice that are developed to support the overarching principles regime. It will be important that these do not create conflicting outcomes with the plethora of existing conduct codes - such as the Code of Banking Practice, the Responsible Lending Code, the existing FAA Code of Professional Conduct and the forthcoming new code of professional conduct for financial services under the FSLAA.

14 We support a principles-based approach to law-making, but care must be taken to minimise subjectivity and to avoid language that is open to various interpretations (particularly when applied in practice), such that it requires regulatory guidance or court decisions. The term "fairness" is the paradigm example of a word that can mean anything to anyone, and therefore forms a poor basis for a law, the boundaries of which should be clear and not arbitrary.

15 Adding a loosely defined and ultimately subjective set of over-arching duties creates an uncertain boundary to an entity's obligations and to the procedures and resources required to discharge them. This will tend to benefit large incumbents and, particularly where underpinned by personal liability on directors and senior managers, will discourage new entrants who by nature will lack that level of scale and resource.

Options to improve product design (Questions 4 – 5)

16 We have concerns with the proposals to give the regulator power to ban or stop the distribution of specific products on the basis that they have poor customer outcomes (Options 1 and 2, although we note that an outright ban of certain products is not a preferred option).

17 Our main concern is that whether products have poor customer outcomes is a highly subjective matter which can often be affected by factors not directly related to the design of the product itself. The example given is insurance policies with particularly poor pay-out rates, but this could be due to many reasons beyond insurers refusing to pay claims. Similarly, poor customer outcomes for financial products could be due to a range of external economic factors, such as material shifts in interest rates or general changes in financial market conditions.

18 If Option 1 is to be pursued, careful thought will need to be given to distinguishing between "poor value" products (reflecting the customer's particular financial situation) and products which are unsuitable for customers in any circumstances.

19 We note that the Australian Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019 (the ***Treasury Laws Amendment Act***), which gives ASIC the power to intervene where a product will, or is likely to result in "significant detriment" to retail customers, is framed to be as objective as possible in its application. However, there are still concerns in Australia as to how it will be used in practice. We recommend that MBIE take account of early lessons from the Australian regime before implementing a similar regime in New Zealand.

20 Option 3, requiring manufacturers to identify the intended audience for products and distributors to have regard to this audience, is potentially attractive. This also forms part of the Treasury Laws Amendment Act and – again – there have been issues in Australia with the breadth of the provision and how it interacts with other financial advisory laws. If MBIE is to proceed with this option, careful consideration of the experience in Australia will be needed.

21 In addition, it is important that the regime does not cut across the consumer protection regimes outside the financial sector - such as the Fair Trading Act 1986 and the Consumer Guarantees Act 1993. A sensible approach might be to apply the suitability disclosure requirement only to those products which have been designed for a particular audience, rather than requiring a pro forma disclosure on products which are designed to have general appeal.

Options to improve product distribution (Questions 6 - 7)

22 A key design consideration in developing policy around permitted remuneration arrangements should be that it not dis-incentivise customers from seeking needed financial advice. There is a lot of evidence to suggest that customers are not willing to pay fees at the level advisers would require to provide the quality and particularity of the advice being sought. Commissions fill this gap. Accordingly, we consider that they should not be banned outright. Having said that, we understand the reasons to ban target-based remuneration (hard or soft) which relies on sales volume targets, except where the commissions come in a form which is beneficial to the advice process, such as training or improved systems.

23 Concerns around churn in the insurance industry, which arguably affects consumers more through higher premiums across the industry than through increased decline rates, should be dealt with directly by requiring that, when customers are being advised to change products, they must be given written product comparisons.

24 In relation to Option 5, we support a duty to take reasonable steps to ensure that the sale of a product will lead to good customer outcomes (although we would want a more specific definition of what constitutes a good outcome), provided there is a suitable delineation between the responsibilities of the distributor and of the product manufacturer.

25 Product manufacturers' obligations should be in respect of customers as a whole, except when dealing with customers directly (for example for claims or complaints). Whether the product is suitable to a particular customer has to be the responsibility of the distributor, as only the distributor is in a position to make this determination.

Options relating specifically to insurance claims

(Questions 8 - 10)

26 Our direct experience of acting for insurers and insureds over many years is that insurers do not intentionally underpay or delay the settlement of valid claims. We have not seen any examples of that occurring, including in the Canterbury earthquake context. We do not consider the examples at paragraphs 101-103 of the Options Paper provide good evidence to support the propositions made in the Options Paper. In our view, the underlying rationale for both of these options is misplaced. We also observe that the example given of delayed claims (over 2000 unresolved claims in Canterbury) may not be apposite. Our understanding is that the vast majority of these claims have either been paid or a settlement has been offered but is being challenged by the insured, i.e. the problem is not speed, but a disagreement over the substance of the settlement.

27 We support in principle the requirement that claims handling is fair, timely and transparent provided that it is made clear that it is only "to the extent reasonable in the circumstances". This is to allow flexibility to deal with different product types and contexts. But we do not think it will have any significant positive effect on insurance settlements. Rather, it could have the unintended consequence of generating more disputes as insureds (even in good faith) use these subjective duties to challenge insurer behaviour as "unfair", "too slow" or "too opaque" because they disagree about the merits of the underlying claim. This would be a particular risk if insureds stood to benefit financially from such a challenge - e.g. if statutory damages were made available for breach.

28 We do not support prescribing timeframes for the settlement of claims. The varied nature of insurance products, the risks insured and the processes required to inquire into and resolve a claim mean that it is not possible to have a single (or even several) effective time frames.

29 In addition, claims can be delayed by the actions or inactions of the customer or third-parties - e.g. if a customer does not produce required claim evidence within a reasonable time. Requiring a customer's agreement to extend timeframes would not be a suitable solution. Customers would inevitably be incentivised to refuse an extension, even if it would be reasonable to agree to one, in order to put pressure on the insurer to accept the customer's position – and potentially to benefit from statutory damages, if these were to be applied.

30 A prescriptive timeframe could also result in insurers paying to settle claims before they are properly assessed in order to meet the deadline and avoid the sanction. The resulting settlement could be too high (inefficiently imposing costs on the insurer with resulting implications for premium rates) or too low (resulting in increased disputes).

31 We consider that concerns about both delayed and incorrect settlements can be addressed most effectively by ensuring that there are efficient and cost effective dispute resolution mechanisms available. For example, the Greater Christchurch Claims Resolution Service in the aftermath of the Canterbury earthquakes appears to be helping to resolve outstanding insurance disputes. We recognise that there is a hurdle for insureds to overcome in initiating a dispute, but this same hurdle will exist whether or not there is also a duty of the sort proposed. The goal should therefore be to make the hurdle lower to ensure resolution of meritorious cases, not to impose different duties in addition to those that already exist under the insurance contract.

Options for tools to ensure compliance (Questions 11 – 16)

EMPOWER AND RESOURCE THE FMA

32 In principle we agree with the proposal that the FMA should monitor and enforce compliance with the good conduct regime. It fits with the "twin peaks" model of financial regulation, and provides consistency with the FMA's regulatory role under the FMCA and the FAA/FSLAA. Also, banks and insurers are used to dealing with the FMA.

ENTITY LICENSING

33 We have reservations with the proposal that banks and insurers be required to obtain a conduct licence - in particular how this would interact with other existing financial markets licence regimes (for example, in respect of derivatives issuers, managed investment schemes and discretionary investment management services) and the Financial Service Providers registration regime.

34 Requiring financial service providers that already have a financial markets licence for their products to also have a conduct licence for the manufacture and distribution of such products could create confusion within the market, result in inconsistencies in approach, and give rise to additional costs.

35 There is also a risk that financial services providers who fall outside the conduct regime (and therefore do not have a conduct licence because they are not required to have one and – indeed – have no ability to obtain one) may be at a competitive disadvantage because, from an uninformed customer's perspective, they are seen as being of a lesser "quality". To avoid this, some investment may be needed to educate customers on the difference between conduct licences and the financial service providers' registration regime.

REGULATORY TOOLS

36 We are broadly supportive of the regulator being given a range of regulatory tools consistent with the powers that the FMA already has under the FMCA.

37 Given that a principles-based approach is proposed, involving a degree of subjective judgement, it is important that the FMA is able to deal flexibly with breaches and to respond proportionately to any harm caused.

PENALTIES REGIME

38 The penalties regime must achieve an appropriate balance between driving compliance and protecting innovation and healthy business risk-taking. Overly cautious behaviour will not produce good customer outcomes.

39 Bright line tests for breaches and heavy pecuniary penalties may not be suitable for a principles-based regime which necessarily includes a significant subjective component. Instead the focus should be effective remediation, which would benefit consumers more directly.

40 We would support a regime that, at least in first instance, prioritises engagement with, rather than enforcement by, regulators. Given our comments below on executive accountability, we consider that pecuniary penalties should be available only where remediation is not occurring or where there is reason to suspect that there are systemic issues which are not being proactively addressed through internal processes.

EXECUTIVE ACCOUNTABILITY

41 The executive accountability regime should be designed to fit the New Zealand context. In particular, it should be aligned with the accountability regime under the FMCA and should take account of the current consultation on director and senior manager accountability under the CCCFA.

42 Directors and senior management will not be able to directly supervise all interactions with customers to ensure that good outcomes are achieved at a "customer by customer" level. They will be responsible for ensuring that there are internal processes in place which are subject to regular monitoring and updating and which ensure that incidents are escalated appropriately and that remediation action is taken - both at the individual customer level and, where necessary, at the broader product design and distribution level.

43 It needs to be recognised that, notwithstanding the implementation of the conduct regime, there will still be occasional instances of poor conduct and cases that "slip through the cracks". What is important is that financial institutions react promptly and appropriately to remedy such incidents and proactively and systematically review their processes to ensure that there are no systemic weaknesses.

44 Executive accountability needs to be considered in this light. Personal liability for individual non-compliance will make directors and senior managers more risk averse, stifling innovation and competition to the detriment of customers. The challenge is to create an accountability regime which provides sufficient clarity to enable banks and insurers to calibrate due diligence programmes and training for directors and senior managers and to implement suitable processes, systems and compliance policies to satisfy their accountability obligations.

45 If the executive accountability regime is to extend to senior managers, there will need to be a bright-line test of who is a "senior manager" so that everyone knows where they stand.

WHISTLEBLOWING

46 We agree that a whistleblowing regime can help create a healthy conduct culture but recommend that, before making any significant changes, there is an in-depth analysis into why existing procedures are not as effective as they could be.

47 We note in this regard that Australia has recently reformed its whistleblowing regime (the Treasury Laws Amendment (Enhancing Whistleblowers Protections) Act 2019). We suggest waiting to see how those changes bed in before any further significant action is taken in New Zealand.

48 The Options Paper suggests the creation of an external body (perhaps the FMA) that individuals could take complaints to if they felt their issues were not being adequately dealt with by the financial institution. We note that the protected disclosure regime under section 45A of the FAA provides for AFAs to report breaches to the FMA. Feedback on the success of that regime would be instructive in the context of this issue. An alternative external body could be the dispute resolution scheme that the financial institution is a member of, such as the Banking Ombudsman. It may be that whistleblowers would feel more comfortable taking their complaints to such organisations, as they would be perceived as being at arms-length from the financial institution/regulator relationship.

REGULAR REPORTING

49 We question whether there would be material benefits from imposing a regular reporting regime on the industry, particularly in the context of customer complaints. We note that the Banking Ombudsman already reports in depth annually on the volume of complaints received about its members and that banks are very mindful of the public response to those statistics. In addition, there are already a number of independent surveys of customer satisfaction levels with banks and financial institutions, for example, the annual banking survey carried out by Consumer NZ.

50 One issue which would need to be considered is how the relevant data is measured, what constitutes a "complaint" or "remediation activities", and whether a distinction is drawn between complaints and adverse comments made in passing which the customer does not intend should be pursued. These concepts would need to be clearly defined for the statistical information to be meaningful and comparable across financial institutions.

Who should the conduct regulation apply to? (Question 19)

APPLICATION OF OPTIONS

51 We agree that, as a starting point, the package of options should apply to banks and insurers in respect of their interaction with retail customers and agree that the definition of "retail investor" under the FMCA, which is the same as "retail client" under the FAA/FSLAA, be used.

52 Ultimately, however, we consider that the regime should apply to all financial service providers. The CCCFA consumer credit regime, FAA/FSLAA financial advisory regime and the FMCA securities regime are all issuer/creditor agnostic. Moreover, with the anticipated growth of intermediaries and fin-techs, it is likely that there will be a broader range of entities providing financial products to customers. It is important not to create a regulatory comparative advantage for smaller organisations which represent greater customer risk because they have less financial and reputational capital at stake.

OVERLAP WITH EXISTING REGULATION

53 One of the recurring themes throughout the Options Paper is the interaction of the new conduct regime with existing legislation.

54 We agree that there are likely to be significant issues with using a "carve out" regime as described in Option 2, given the potential complexity of such a regime and the material risk that there will be "gaps" which could be exploited by financial institutions.

55 Our preference, therefore, would be for Option 1, the "overlay" onto existing regulation. While this will create parallel regimes, we consider the benefit of having a consistent regulatory umbrella for all conduct will outweigh the time and effort that will be needed to eliminate as much inconsistency as possible, and to incorporate a clear set of overriding principles that apply where residual conflicts arise.

AUCKLAND
23 Albert Street
PO Box 2206, Auckland 1140
New Zealand
T: +64 9 357 9000
F: +64 9 357 9099

WELLINGTON
10 Customhouse Quay
PO Box 993, Wellington 6140
New Zealand
T: +64 4 499 5999
F: +64 4 472 7111

CHRISTCHURCH
60 Cashel Street
PO Box 2510, Christchurch 8140
New Zealand
T: +64 3 353 4130
F: +64 3 365 4587

www.chapmantripp.com