

29 May 2018

Finance and Expenditure Select Committee Briefing Note: Financial Services Conduct and Culture review

This briefing note has been prepared in response to the request from the Finance and Expenditure select committee for the Reserve Bank of New Zealand (RBNZ) and the Financial Markets Authority (FMA) to brief the committee on the Australian Royal Commission (RC) into Misconduct in the Banking, Superannuation and Financial Services Industry. It provides a background on the RC and outlines the response by regulators in New Zealand.

Executive Summary

- The instances of conduct examined at the RC to-date were mostly already known to the Australian regulators and have influenced the work programmes of the NZ regulators.
- The RBNZ and the FMA are taking the issues that have been highlighted by the RC in Australia very seriously.
- We have asked banks, and life insurers, to provide assurances that the same conduct issues are not evident in New Zealand and to show us what work has been done to identify and address any conduct and culture issues.
- A rigorous approach is being applied to our review of banks' and insurers' conduct and culture, and a high bar has been set for them to meet our expectations.
- In our existing monitoring work to date we have not seen evidence of systemic issues to warrant a commission of inquiry in New Zealand, however the work we have initiated will test this view.
- Banks have provided responses to our request which are now being assessed with further verification and information to be requested where necessary.
- We will report on the findings of the review once we have fully examined the responses and tested whether and how the governance frameworks, systems and controls and core processes described by the banks work in practice.

Background

The Australian Royal Commission into misconduct in the Banking, Superannuation and Financial Services Industry was established on 14 December 2017. It was established to respond to a series of known misconduct incidents within financial services over a lengthy period. The banks themselves eventually called for an inquiry to stem the ongoing reputational harm created by uncertainty regarding an inquiry.

In 2014, a Senate committee recommended a Royal Commission after it found that the Commonwealth Bank of Australia's financial planning division had systematically been putting clients' savings into high risk investments contrary to clients' best interests, so that advisers could earn higher commissions.

A number of high profile examples of misconduct contributed to building pressure to hold a commission of inquiry. On 30 November 2017, after an approach by the major banks, the Australian Prime Minister announced a Royal Commission was necessary because "ongoing speculation...is disruptive and risks undermining the reputation of Australia's world-class financial system."

The RC has broad terms of reference to inquire into any misconduct by financial services entities and whether any conduct, practices or activity has fallen below community standards and expectations. It was also called to look at culture and governance (both within firms and across the sector), mechanisms for redress and the adequacy of existing laws and policies, and forms of industry self-regulation. The RC is also to consider the capability of regulators and recommendations for legislative change. Enforcement action may also result from some of the misconduct disclosures.

To date three rounds of public hearings have been held:

1. Consumer lending 13-23 March
2. Financial advice 16-27 April
3. SME lending 21 May-1 June

As at 25 May, the commission has received 6014 public submissions with 65% related to banking, 10% financial advice and 10% superannuation.

The commission is expected to issue an initial report in September 2018 and a final report, with recommendations, by February 2019.

Issues highlighted

The public hearings have featured case studies and testimonies that highlighted generally well-known past issues. The first round heard evidence on inappropriate lending and credit practices related to credit card, car finance and residential mortgages. Second round issues focused on poor and inappropriate financial advice including charging fees for no service, charging deceased clients, acting without authorisation and false representation. It was also revealed that a regulator had been misled in regard to charging for services never provided. The third round has considered issues with guarantors for business loans, indemnities, mortgage documents and unfair contracts.

In addition, on 1 May the Australian Prudential Regulation Authority (APRA) released a report of the independent panel review of the Commonwealth Bank of Australia (CBA). The report was triggered by concerns about governance, accountability and culture at CBA. It found significant deficiencies in culture, risk management, governance and reporting.

New Zealand regulators response

New Zealand regulators have been monitoring the RC since it was initiated and have discussed matters with Australian regulators on a number of occasions. There has been significant focus on conduct within financial services from the FMA since the passing of the Financial Markets Conduct Act in late 2013. This is demonstrated by the public consultation on the FMA Conduct Guide in 2016, culminating in its publication in February 2017. Authorised financial advisers have been operating under an enforceable Code of Conduct since 2010. The FMA's supervision programme includes focus on areas of conduct risk highlighted in overseas jurisdictions, particularly Australia, such as insurance replacement business, bank incentive structures, and soft commissions. Some potential gaps in our regulation of financial markets conduct are being examined in the current reviews of financial adviser legislation and insurance contracts and conduct.

Our concern about the RC's impact on confidence in our financial institutions and the risk of complacency in the New Zealand industry to these culture and conduct issues led us to respond. The volume of New Zealand media coverage and commentary on the RC has raised public questions and speculation about whether there were also systemic conduct issues in New Zealand.

As the RC's hearings progressed, the RBNZ and the FMA discussed these issues individually with New Zealand bank CEO's. On 30 April the RBNZ Governor and the FMA Chief Executive met with 16 chief executives of New Zealand banks, including the four major Australia owned banks. The purpose of

the meeting was to seek assurance that the issues identified in Australia were not evident in New Zealand.

A number of bank CEOs and the New Zealand Bankers Association have publicly stated their confidence that their New Zealand operations do not have systemic conduct issues of the nature and extent seen in Australia.

Following the meeting with bank CEOs, the RBNZ and the FMA, with the support of the Commerce Commission, wrote to ten locally-incorporated New Zealand banks with major retail operations on 3 May. RBNZ and the FMA published the letter which has been widely reported on. The letter stated:

“Our objective in this exercise is to understand what work you have undertaken to review your operations to promptly identify and address any conduct and culture issues. We expect you to show us what you have done in order to be comfortable that there are no material conduct issues within your business... the purpose of this exercise is to understand how you as leaders of your businesses have obtained assurance that misconduct of the type highlighted in Australia is not taking place here. “

Banks were given a deadline of 18 May to respond.

Notwithstanding that insurance has not featured in the RC at this stage, we have written similarly to 15 major life insurance companies on 23 May, with the request that they respond by 22 June. This reflects significant work undertaken by the FMA since 2016 on sales and advice practices within life insurance and concerns over the remuneration structures used by insurance providers to encourage the sale and replacement of life insurance policies.

The later response date for insurers will enable joint regulators to substantially progress the review work with banks, prior to commencing the review of insurers’ submissions. It also allows time for insurance companies to respond to the review of insurance contract law that has been initiated by the Minister of Commerce and Consumer Affairs and which includes consultation on the appropriate regulatory approach for conduct in the insurance sector.

A special meeting of the Council of Financial Regulators (CoFR) was also held on 2 May to discuss a coordinated approach in response to matters raised by the RC. CoFR members are: RBNZ, the FMA, Treasury and MBIE. The Commerce Commission also attended as a number of the issues are within its regulatory remit.

Scope of Review

At this stage our focus is on the major retail banks and life insurers. Once we have an initial view on the themes arising from this stage and the next steps we are required to take, we will assess whether other sectors of financial services will also be included. While we can’t rule out extending our review in the future, we are mindful that a robust and credible work plan is needed for these first two sectors and significant resource will need to be applied within the regulators.

Assessment of bank responses

Eleven banks provided their responses by the 18 May deadline. A joint working group of FMA and RBNZ staff has been formed to review the responses. The Commerce Commission is also reviewing matters relevant to its remit.

Over the last week, we have undertaken a very preliminary look at the material to assess what has been submitted and in order to categorise it for further assessment.

Next steps are to review all the material in more depth, testing the validity, comprehensiveness and adequacy of the material, identifying issues for deeper investigation (including testing the operation of key processes and governance mechanisms), which may include independent assurance and on-site reviews.

We will examine the information under a number of key themes, including:

- Governance
- Risk Management Framework / Risk Culture
- Suitability of sales processes, channels and incentives
- Complaints and Remediation Processes/ Programmes
- Conduct

As we progress our inquiries, we will also identify any areas within the framework for regulation of retail financial services where we consider there are regulatory or supervisory gaps or inefficiencies. This will include any gaps we find in the legislative tools or powers available to us to address any issues we find. We expect to report on these findings in October/November. This timing partly reflects the timing of the initial report from the RC (expected by end September, 2018).

Initial observations

- The submissions are generally extensive and for the most part appear relevant to our request.
- Preliminary assessment has identified some variance in the detail provided and the extent of work already completed and expected to be conducted in the future.
- Some responses indicate a mature and embedded approach to conduct risk, while other banks have not yet begun to fully embed specific conduct governance and oversight into their operations. We will be following up with all the banks on these aspects
- The responses also cover:
 - a description of internal and external reviews conducted in recent years
 - future programmes of work to address a number of areas and provide additional assurance
 - examples of disputes or complaints and their remediation processes.
- Following the initial assessment, we will be requesting further information and verification where necessary.

A high bar will be set in meeting our expectations and demonstrating a sufficient level of assurance in regard to good conduct and culture.

Findings update

The RBNZ and the FMA are committed to undertaking a rigorous review of operations within banks and life insurers to gain the best possible assurance that there are no material conduct and culture issues in New Zealand. This process requires detailed examination of information provided and verification of appropriate governance systems and controls.

We would welcome the opportunity to update the Finance and Expenditure Select Committee on our findings in relation to banks around October, followed later by life insurers.

Current legislative initiatives and reviews, and regulatory work programmes

It is important to note that a number of relevant legislative frameworks are already under review, and both the FMA and RBNZ have significant work programmes across a number of relevant sectors. For example:

- The Financial Services Legislative Amendment Bill currently before the Economic Development Select Committee. This will strengthen the financial advice regime, and address issues identified by a review undertaken by MBIE in 2015 including:

- consistent conduct and competence standards for all financial advice, including a Code of Conduct to set standards of ethics, client care and competence
 - restrictions on how financial advice firms can incentivise their staff
 - plain-English disclosure
 - licensing regime and ongoing supervision by the FMA
 - flexible and modern enforcement and discipline regime with increased civil liabilities.
- A review of Insurance Contracts law has been commenced by the Minister of Commerce and Consumer Affairs which includes a review of the regulatory framework for conduct within the sector as highlighted by the 2017 IMF report.
- MBIE is also undertaking a review of the regulation of consumer credit under the Credit Contracts and Consumer Finance Act and will be issuing a discussion paper with proposed options in June. This will address irresponsible and predatory lending.
- Bank incentive structures for sales and advice are being reviewed by the FMA and will be reported on by the end of the year.
- FMA has just reported on its a review of soft commissions offered to advisers and brokers by insurance providers. A report on the FMA review of insurance replacement business practices of authorised firms is to be published in early July.
- Last year the RBNZ undertook a thematic review of the bank director attestation regime. Primary responsibility of bank directors and senior managers for managing risks is a fundamental element of prudential regulation and supervision. As a consequence of the review RBNZ has adjusted its annual engagement plan to increase the number of director meetings.
- The RBNZ engages regularly with bank boards to discuss how they manage risk within their businesses.
- The Commerce Commission has a busy portfolio of advocacy and enforcement work in relation to its remit under the CCCFA, as well as participating extensively in the several credit law reform workstreams that MBIE is initiating. The Commission's current focus is on building compliance with responsible lending laws, including through initiating Court action; challenging oppressive conduct by lenders, including lending on oppressive terms; continuing to challenge fees that over-recover lender costs; and building understanding of the practices of high-cost short-term lenders and motor vehicle lenders. The Commission is also working through some lending and disclosure errors by banks and other lenders, and considering suitable remediation outcomes.

Ends.