COFR Q3 2018 ENVIRONMENTAL SCAN

September 2018

The **Council of Financial Regulators** (CoFR) aims to contribute to the efficiency and effectiveness of the regulation of New Zealand's financial markets, and promote the stability of the New Zealand financial system. CoFR's objectives include:

- Sharing information on the strategic priorities of members;
- Identifying important issues and trends, which may impact the regulatory objectives of members; and
- Providing for coordinated responses to issues where necessary.

This Environmental Scan is designed to assist in pursuing these objectives through focusing discussion on key changes, trends and emerging risks in New Zealand's financial system.

In scanning the environment we focus on two elements:

1. ***Recent key developments and trends across financial market sectors*** – outlining changes we have observed across Banking, Insurance, Financial Advice, Capital Markets and Investment Management.
2. ***Key drivers of change*** – including:
   - Macroeconomic drivers;
   - Domestic and international policy and regulatory developments;
   - Technology, innovation and product developments;
   - Developments in market structure and/or firm behaviour; and
   - Changes in consumer and investor behaviour.

FMA
FINANCIAL MARKETS AUTHORITY

MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

RESERVE BANK OF NEW ZEALAND
TE PŪTEA MATUA

THE TREASURY
Kaitohutohu Kaupapa Rawa

September 2018

1 - SUMMARY & MACRO-CONDITIONS

Summary – This Environmental Scan highlights the many and varied factors driving change in New Zealand's financial markets and therefore the risk landscape.

- Macroeconomic conditions remain positive, however the International Monetary Fund has signalled the balance of risks shifting to the downside, driven largely by geopolitical considerations.
- Significant legislation review and development are underway in New Zealand – including a review of insurance contract law, Reserve Bank Act review, passage of the financial adviser reforms, review of consumer credit regulation, and legislative changes to facilitate compliance with foreign margin rules for OTC derivatives.
- The Australian Royal Commission has gained significant attention in both Australia and New Zealand, which has resulted in a co-ordinated response by the FMA and RBNZ. The regulators are seeking assurance from banks that the systemic issues highlighted in Australia are not present in New Zealand. To date, the Australian Royal Commission has focused on issues of incentives, culture, and engagement with regulators.
- Internationally, prevailing themes of enhanced accountability and increased enforcement powers have come to the fore. Specifically, in Australia the Banking Executive Accountability Regime has come into effect and ASIC will be given greater enforcement powers and resources.

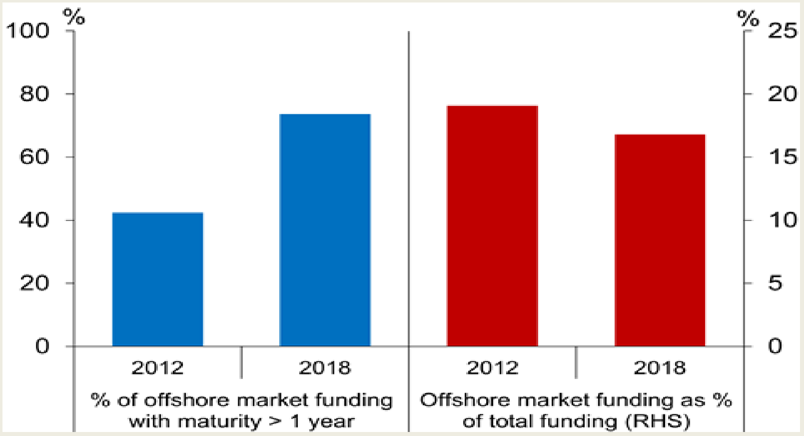
Macroeconomic conditions

The August 2018 Monetary Policy Statement noted the Official Cash Rate (OCR) is expected to remain at 1.75 percent through 2019 and into 2020. This timeframe for the expansionary level of the OCR is longer than that projected in the May Statement, and is needed to meet the RBNZ's price stability and employment objectives.

Domestically it is anticipated that economic growth will rise over the rest of the year, and be maintained through 2019. There are also early signs of core inflation rising, and expectations that the unemployment rate will decline modestly from its current level.

A recent report from the NZ Productivity Commission noted 'capital shallowness' continued to limit productivity growth in New Zealand. New Zealand's banking system requires market funding to finance its lending and relies on overseas funding. This exposes it to increased liquidity risk, particularly during periods of financial stress.

Banking system offshore market funding
(July years)



(RBNZ Liquidity Survey)

The RBNZ expects global inflation pressures to rise while trading-partner growth will remain robust. Central banks continue to withdraw monetary stimulus, resulting in overseas interest rates increasing relative to New Zealand, which may impact trade balances.

The IMF projects global growth to reach 3.9 percent in 2018 and 2019 – an increase from the 3.7 percent achieved in 2017. Whilst the global economic outlook remains positive, the IMF warns the balance of risks has shifted further to the downside, including in the short-term a number of geopolitical risks, such as rising trade tensions (between the United States and China) and the management of Brexit.

The United States has implemented tariffs on US$250 billion of imports from China, and China has responded with measures, but of a smaller scale. Approximately 20 percent of New Zealand's exports go to China and around 10 percent go to the United States. The impact of the announced tariffs on New Zealand activity is expected to be limited. However, if the trade conflict escalates, the impact on New Zealand would be more significant.

The Governor of the Bank of England has recently warned of the potential catastrophic consequences of a 'no-deal-Brexit', including a 35 percent drop in UK house prices.

2 - TRENDS AND DEVELOPMENTS: BANKING AND INSURANCE

September 2018

Banking/non-bank deposit takers

Three of the major New Zealand banks reported half-year profits in May. All reported increases in cash earnings. The results have been stated to reflect the strength in the housing market, growth of KiwiSaver, wider economic performance, and increases in net interest margin.

Cash earnings	1H2018	1H2017	Increase
Westpac	$482m	$463m	4.1%
BNZ	$494m	$455m	8.6%
ANZ	$941m	$928m	1.4%

(NZ banks half-year results)

RBNZ’s May Financial Stability Report found banks remain adequately capitalised and have sufficient liquidity buffers. Key risks to the financial system (ie, high and concentrated household and dairy sector indebtedness, and exposure to international risks) are more benign than in recent years, but continue to be closely monitored.

There are a number of reviews that will impact the banking sector. These include the review of the Reserve Bank Act, which examines whether the RBNZ’s monetary and financial policy frameworks provide the most efficient and effective model. The review is divided into two phases, with Phase 2 currently underway. There is also a review of the capital adequacy framework for registered banks. Public consultation is ongoing and key decisions are expected by the first quarter of 2019.

Open banking developments continue. It offers the potential benefit of enabling providers to offer a wide range of new financial services (for example, more developed retail payment mechanisms) and empowers consumers with increased choice. However, it could also lead to an increased risk of data mishandling, and the greater competition of new entrants could weaken the profitability of banks that are slow to adapt to the changing financial system landscape. Payments New Zealand’s Payments Direction initiative is developing and piloting application programming interfaces (APIs) with a number of New Zealand banks. APIs are the basis for data sharing and interoperability that underpin the concept of open banking. Datacom, Westpac and Opotiki District Council have set up an open banking API that enables payment for Westpac customers from the council’s website.

Bank accountability has been a recurring theme internationally. In Australia, the Banking Executive Accountability Regime (BEAR) formally came into effect on 1 July 2018 for the largest banks. In the UK, the FCA recently published rules for how it will extend the Senior Managers and Certification Regime, which will apply to insurers from December.

The Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

The Australian Royal Commission is looking into the conduct of the banking, superannuation and financial services industry – and whether these institutions have fallen below community standards and expectations. The Commission has gained significant attention in both Australia and New Zealand. The Commission’s interim report is due by 30 September and a final report by 1 February 2019. The focus areas of the six hearings to date have been consumer lending practices, financial advice, loans to small and medium enterprises, remote and regional community banking, superannuation and insurance. The seventh round of public hearings, to be held in November, will focus on policy questions arising from the first six rounds.

New Zealand Conduct and Culture Review

The FMA and RBNZ have initiated a review of conduct and culture of New Zealand based retail banks and life insurers, in response to issues raised by the Australian Royal Commission. The review is making assessments across four broad themes: governance, conduct risk management, customer-focused implementation and remediation. The on-site reviews of banks have been completed and on-site reviews of insurance firms have begun. The FMA and RBNZ expect to be able to publish a report on our findings in the banking sector in early November and a report on life insurers in December.

Insurance

Despite the weather-related insurance claims, the insurance sector remains sound. However, a rise in interest rates or a natural catastrophe could see capital exit the market, and reinsurance costs may rise.

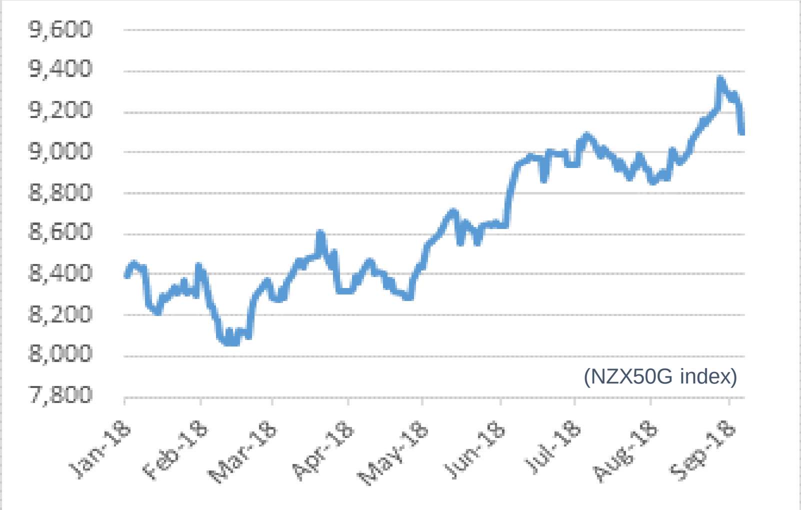
The initial round of consultation has closed for the Insurance Contract Law Review, which includes consideration of the conduct regulation of insurers. MBIE is currently considering submissions and analysing options before providing advice to Ministers. The FMA has published three insurance-related reports this year on insurance churn, soft commissions, and QFE replacement business. An emerging theme is poor practices in relation to incentives, managing conflicts of interest, and record-keeping. The FMA has sought to emphasise that insurance providers must take some responsibility for the behaviour of advisers.

3 - TRENDS AND DEVELOPMENTS: CAPITAL MARKETS

September 2018

Capital markets

While the NZX index valuation remains strong and trading has increased, IPO activity remains stagnant.



The exchange's 2017 refreshed strategy emphasised important initiatives including driving secondary market development, further improving liquidity levels and enhancing price transparency. To this end, the NZX has confirmed changes to its trading and clearing pricing structure, which will take effect in October. These changes follow the trial of a new pricing structure in the secondary market over the past 12 months. This trial is stated to have contributed to an increase of on-market activity, from 39.8 percent to 53.3 percent. Commentators have noted much of this liquidity is likely to have come from an increase in algorithmic trading.

The FMA's review of how well NZX is meeting its licensed market operator obligations found NZX generally compliant, except in relation to a lack of market expertise in the market surveillance function. NZX has undertaken to increase resource in this area.

The NZX was also recently hit by an outage that lasted almost a day, highlighting the ongoing challenge of managing IT risks.

Market Capitalisation	Aug. 2018	Change YoY	% of GDP
All equity	$138,314 m	11.9%	48.3%
All funds	$3,965 m	15.7%	1.4%
All other	$7 m	59.0%	0.0%
Total equity	$142,286 m	12.0%	49.7%
Debt	$27,314 m	-3.2%	9.5%
Green bonds	$672 m	-	0.2%
Total NZDX	$27,986 m	-0.8%	9.8%

(NZX Limited - monthly shareholder metrics, August 2018)

Exchange traded funds – The International Organization of Securities Commissions (IOSCO) has initiated work on the stability risks associated with the continued rise of passive investment strategies. This builds on recent work on liquidity risks in passive and mutual funds.

Audit – Globally, there have been confidence concerns in the role and function of auditors. The International Forum of Independent Audit Regulators has found that, according to audit regulators, auditors did not obtain reasonable assurance that financial reports were free of material misstatement in 40 percent of audits reviewed by audit regulators. As part of its investigation into the conduct of CBL Corporation Limited and its directors, the FMA is considering the performance of the auditor, Deloitte.

Corporate governance – Recent months have seen a number of corporate problems in NZ-listed companies. The FMA has identified concerns with information flows between management and the boards. The FMA has recently published a quick reference guide outlining some of the legal requirements, ethical considerations and best practice areas for directors to consider, to be effective in their role.

Investment management

The process for the next appointment of default KiwiSaver providers will start in 2019. The review will investigate fees and ethical investment.

Fees also remain an issue of interest. In April, Nikko Asset Management launched its KiwiSaver scheme, offering to waive management fees for a period. The FMA is working to build a better understanding of fee competition and practices across the KiwiSaver market

An external review of fees and costs disclosure in the Australian managed fund space indicated that fee disclosure in New Zealand is simpler and deliberately less inclusive than for Australian funds – although it noted this was aided by comparatively limited product diversity.

Financial advice

The new regime for financial advice continues to progress. In September, the Financial Services Legislation Amendment Bill passed its second reading in the House with unanimous support.

In February, the FMA opened applications for an exemption for providers to be able to offer personalised digital advice. To date, the FMA has granted two exemptions for digital advice.

September 2018

4 - DRIVERS: POLICY, REGULATION & TECHNOLOGY

Other domestic regulatory and policy developments

Consultation on the Credit Contracts and Consumer Finance Act (2003) has closed. MBIE is considering responses; policy decisions will be announced later this year.

There is also the development of a new regulatory regime for financial market infrastructures.

Globally the roll-out of new margin rules for OTC derivatives is continuing, with the next tranche of entities (including several New Zealand institutions) being covered from September.

The Tax Working Group has been established by the government to examine the structure, fairness and balance of the tax system. This includes "whether the tax system promotes the right balance between supporting the productive economy and the speculative economy", including the relative treatment of different types of investments. Its interim report has been published.

International regulatory developments

We monitor international regulatory developments to identify potential impacts on New Zealand's financial markets, as well as identify international regulatory trends and best practice.

Financial regulation in Australia is subject to a significant reform agenda in addition to the Australian Royal Commission. Financial product governance obligations and intervention powers are due to be introduced, as are whistleblower reforms and the adoption of a competition mandate by ASIC. The Australian Government has also agreed, in principle, to recommendations made in the ASIC Enforcement Review Taskforce Report, which seeks to strengthen ASIC's powers in a number of areas. ASIC has received an additional $70.1 million in funding to accelerate and expand its enforcement and supervisory work.

The Australian Financial Complaints Authority has also received Ministerial authorisation; establishing a single scheme for all financial services disputes under ASIC's oversight.

The Australian Productivity Commission's report into competition in the Australian financial system has found that poor market outcomes are evident given that banks, and in particular the major banks, exhibit substantial pricing power.

Further afield, the European Union's (EU's) General Data Protection Regulation (GDPR) came into force on 25 May 2018. It imposes significant new requirements on holders of personal data of EU citizens and will apply to New Zealand businesses that operate in the EU. GDPR also requires data breach reporting.

A Financial Stability Board report on mitigating conduct risk highlights the systemic risks posed by the creation of mistrust and weakening ability of markets to allocate capital. Chair Mark Carney noted that the resources paid in fines could have supported up to USD$5 trillion in lending.

Industry	2014	2015	2016	2017	2018	5 yr. Trend
Technology	75%	73%	74%	75%	74%	-1
Health Care	-	-	62%	66%	64%	-
Energy	57%	56%	58%	62%	63%	+6
Food And Beverage	64%	63%	64%	66%	63%	-1
Telecommunications	61%	59%	60%	63%	63%	+2
Automotive	69%	66%	60%	65%	62%	-7
Entertainment	64%	63%	64%	64%	62%	-2
Consumer Packaged Goods	61%	60%	61%	63%	60%	-1
Financial Services	48%	48%	51%	54%	54%	+6

(2018 Edelman Trust Barometer)

The 2018 Edelman Trust Barometer found financial services was one of the least trusted sectors (to do 'what is right'), with a score of 54 per cent.

The Central Bank of Ireland published its Behaviour and Culture Report of Irish Retail Banks. The report finds that while banks have exhibited improvements, two important prerequisites for successful transformation were not met in some instances: a collective understanding of what consumer focus means and what behaviour it requires, and an embedded consumer focus in structures, processes and system.

Technology innovation and product development

The FMA is continuing to maintain a close watch on cryptocurrencies and initial coin offering (ICOs), and released information for potential issuers and consumers. The RBNZ has published research on how digital currency might impact central bank functions. IOSCO is also developing a support framework to assist its members in considering how to address domestic and cross-border issues stemming from ICOs.

The IMF has estimated annual potential losses from cyber-attacks may be large, close to 9 percent of banks' net income globally, or around USD$100 billion. The Bank of England has recently announced its intention to stress test banks and other financial institutions for cyber attacks.

Climate change

The International Association of Insurance Supervisors has released an issues paper on the climate risk to the insurance sector, in response to increasing recognition at the global level that climate change will also affect the financial system. The objective of the paper is to raise awareness for insurers and supervisors of the challenges, including current and proposed supervisory approaches for managing climate risks.