Financial Law Insight - The FMA and RBNZ's report on bank conduct and culture

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On 5 November 2018, the Financial Markets Authority ('FMA') and the Reserve Bank of New Zealand ('RBNZ') released a report on the findings of their joint review of conduct and culture in the New Zealand banking sector ('Report').

Unlike the findings of the Australian Royal Commission ('ARC') in its interim report on *Misconduct in the Banking, Superannuation and Financial Services Industry*, the Report did not unearth any widespread misconduct and culture issues. However, the regulators found weaknesses in a number of areas, and have made it clear that they expect New Zealand banks to take proactive steps to prevent any widespread issues occurring in the future.

In this *Financial Law Insight* we share our views on the Report – including its relevance to the broader financial services industry, the key learnings for market participants to start thinking about now, what we anticipate will happen next, and other upcoming conduct-related issues that market participants should be aware of.

In brief:

- The Report focuses on the conduct of New Zealand's eleven largest retail banks, as reviewed by the FMA and the RBNZ over a four-month period.
- The Report did not unearth any widespread conduct and culture issues, but it is far from a glowing report card. Instead, the regulators have placed the onus on banks to proactively strengthen their governance and management of conduct risks, to mitigate the risks of any widespread issues occurring in the future.
- In addition to the Report, the regulators will be providing specific findings to individual banks. Each bank will need to develop a plan to address the findings, and to report progress by the end of March 2019.
- The 'regulatory gap' is a focus of the Report. However, we are sceptical that new banking conduct laws will be developed as a result. Granting the FMA broader supervisory and enforcement powers is likely to be the favoured option.
- While the focus is on banks, the Report contains important learnings for the broader financial services industry to consider, with the emphasis on 'culture' likely to set the tone for other upcoming industry reviews.

In full:

With the dust having settled a little following initial reactions to the release of the Report earlier this month, the banking sector will no doubt now be working on where exactly to go from here. But it's not just the banking sector that should be doing this. The broader financial services industry ignores the Report at its peril…

Why the broader financial services industry should take note

The Report expressly notes that all financial service providers would benefit from assessing their conduct against the Report's recommendations – including those in the wholesale space.

Insurance participants in particular should be taking note. We think it is a fair bet that the findings in the Report will form much of the template for the life insurance conduct and culture review due to be reported on next month. It will also be relevant to the insurance contract law review currently underway.

Similarly, the Report is likely to provide a strong indication of the FMA's expectations for financial advice providers ahead of upcoming financial advice provider licensing preparations.

So, what can market participants start working on now in light of the Report?

The Report's key recommendations

There has already been much material released summarising elements of the Report, and market participants should refer to the Report itself for the regulators' recommendations and detailed findings. For convenience, we summarise the key recommendations below – but, first, a sharp wake-up call!

Any financial service providers who have not yet compared their conduct to the principles in the FMA's Conduct Guide, and taken appropriate action where necessary, should be putting this at the top of their to-do lists. The FMA has reiterated its expectation that all financial service providers should have done this, expressed at the time of the Guide's publication in February 2017.

The Conduct Guide provides some cornerstone principles, which set the foundation for the following key recommendations set out in the Report:

- **Board ownership and accountability for conduct and culture** – Boards need to take ownership for driving positive change in conduct and culture. Effective measurement and reporting on conduct and culture risks and issues needs to be developed. This should include both 'lead' and 'lag' indicators as well as ensuring that it is easy for customers to raise concerns, and that any concerns (and any trends) are adequately reported to boards.

- **Identify and remediate issues** – Issues need to be proactively identified and remediated, and all banks should review their conduct against the issues identified by the ARC. If no issues are identified, check again, as the regulators suspect this is likely to indicate a failure in the processes and systems for identifying and recording issues. The regulators were sceptical of 'no issues here' claims.

- **Strengthen processes and controls** – Investment must be prioritised in strengthening the frameworks, processes, and controls that prevent, detect, and manage conduct and culture issues.

- **Staff reporting channels** – Staff need to be able, and supported, to report any conduct issues through accessible, confidential, and comprehensive reporting channels.

- **Incentives** – Incentive structures need to be designed with good customer outcomes in mind, and all incentives linked to sales measures should be removed. Banks are expected to implement changes to incentive structures no later than the first performance year after 30 September 2019, and must report to the regulators in March 2019 about how they will do this. Any bank that does not commit to removing sales incentives for sales people and their managers must explain how they will address the risks of poor conduct that arise from these incentives.

Those are the headline messages. There are plenty of additional points and further details to consider in the 38 page report.

In light of the above, now is the time for all financial service providers (both bank and non-bank providers) to review their conduct against the Report's recommendations, and identify where there is room for improvement.

In particular, a number of providers will have incentive structures in place that may be viewed as problematic in light of the Report's recommendations. These providers should start giving thought to these issues now, as it may be a challenge for them to make changes given historical structures and existing contractual obligations.

Banks will need to prioritise this review to ensure they can meet the fast-approaching March 2019 reporting deadline, having regard to the FMA's separate review of bank incentive sales structures due to be released mid-November 2018.

What actions are we anticipating will flow from the Report?

The Report includes a dedicated section focusing on gaps in the retail banking regulatory environment. Unsurprisingly, the Report concludes that the issues identified in the Report are not the result of gaps in regulation. However, a conduct regulation gap does exist, with there being no specific law under which the regulators can enforce conduct issues in the retail banking sector.

Various options for the government to deal with the gap are put forward in the Report, including:

- establishing basic legal duties on banks to protect or enhance customer interests and outcomes
- requiring banks to have adequate conduct-based systems and controls in place
- providing regulators with sufficient supervision and enforcement powers
- clarifying accountability and individual responsibility for management of conduct – including by imposing direct liability on senior managers.

We think it unlikely that new banking conduct laws will be developed in response to the Report. Doing so would be inconsistent with the conclusion reached by the ARC: adding more layers of new law is not the solution. Simple laws are key. This sentiment especially rings true in New Zealand, with the regulatory landscape having already gone through extensive change over the last few years (with the introduction of the Financial Markets Conduct Act regime), and with more changes coming in the near future (including via the Financial Services Legislation Amendment Bill, and the announced changes for clearer responsible lending requirements and tougher penalties under the Credit Contracts and Consumer Finance Act 2003).

Instead, we anticipate seeing the regulatory gap closed via a more holistic approach. This is likely to involve expanding the FMA's power to regulate the conduct of the wider financial service providers community – including both banks and insurers (who do not currently form part of the community regulated by the FMA).

If all else fails, the FMA has indicated that it is not above 'naming and shaming' providers if it needs to. In this digital age, this may be as an effective tool as any.

Regardless, we anticipate seeing a continued focus on conduct and culture in other upcoming reviews – including in both the insurance contract law review currently underway, and in the FMA's approach to financial advice provider licensing ahead of the financial advice reforms.

RBNZ's regulatory powers

The Report's findings should also be read in the context of the review of the Reserve Bank of New Zealand Act 1989 ('RBNZ Act'). Phase 2 of that project includes a comprehensive review of the financial policy provisions of the RBNZ Act that provide the legislative basis for prudential regulation and supervision. One of the key questions of this review relates to who, what, and how the RBNZ should be regulating.

Interestingly, the Report did not identify any notable regulatory gaps for the RBNZ from a prudential perspective. The regulators noted the RBNZ already has sufficient powers, tools, and flexibility to investigate and respond to prudential issues related to risk culture, risk governance, and risk management.

Presumably that finding flows across to the RBNZ's prudential role in relation to insurers. The Report is therefore unlikely to provide a catalyst for the RBNZ to resume its active work in relation to the review of the Insurance Prudential Supervision Act 2010 that was suspended in April this year.

Next steps

Prior to the Financial Markets Conduct Act regime, the focus of regulatory compliance was overwhelmingly on adherence to the black letter of the law. We have since seen a quantum shift towards a focus on good conduct and culture, which now operate as a broad unwritten framework within which legally prescribed requirements exist and operate. The establishment of the FMA was a major catalyst for this journey in New Zealand.

What are the next steps in this financial service providers' conduct and culture revolution that we have witnessed over the last few years?

Market participants should be aware of the following upcoming conduct-related items:

- **15 November 2018:** The FMA's review on bank incentive structures for sales is due to be released.
- **December 2018:** FMA to report on its Insurer Conduct and Culture Review.
- **Late 2018:** MBIE to release options paper on insurance contract law review for public consultation.
- **1 February 2019:** The final report of the ARC into Misconduct in the Banking, Superannuation and Financial Services Industry is due to be released.
- **March 2019:** Banks to report to the regulators in response to the conduct and culture review, as well as in relation to their plans for changing their incentive structures.

Actions to take now

While this is not a black letter law requirement, some immediate actions all financial service providers can take to demonstrate they are getting the regulators' message include:

- ensure they have conducted a review against the FMA's Guide to Conduct
- conduct a review against the key themes from the Bank Conduct and Culture Report and the ARC findings
- take appropriate action in respect of any gaps identified as a result of conducting the above reviews.

Start a conversation

If you would like a specific briefing on the Report and what your business can take from it, or would like assistance with your own gap analysis, please contact one of the key contacts.

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