Update on the FMA's ongoing review of insurance replacement business and conflicted conduct

March 2018

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

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Executive summary

Purpose of the report

This report follows on from our 2016 report, Replacing life insurance – who benefits? into replacement business activity within the adviser sales channel of the New Zealand life insurance market.
It details our findings, the results of our inquiries to date and our expectations for advisers when they are providing advice on replacing insurance policies.

Why are we concerned about conflicted conduct?

Our Strategic Risk Outlook (SRO) highlights the risks and harms associated with conflicted conduct across all financial services.

The four strategic priorities that reflect the risks associated with poor quality advice for the replacement of insurance policies are:

- Governance and culture
- Conflicted conduct
- Sales and advice
- Investor decision-making

This report focuses on one area of conflicted conduct in financial services, in the sales and advice around replacement business activity in the life insurance industry.

The risk of conflicted conduct in the life insurance sector is exacerbated by up-front commissions and incentives, which focus on sales targets rather than customer needs. While this report is focused on insurance advisers, we expect all financial service providers to manage conflicts appropriately so they can demonstrate they are considering customer needs and outcomes at all times.

We discovered through our inquiries that many registered financial advisers (RFAs)[1] were unaware they need to manage conflicts of interest. A conflict of interest exists where a person with a duty to perform a task could be affected by some other interest while performing the task. One of the most common sources of conflicts of interest is remuneration or incentives that could influence advice given by an adviser to a consumer.

Customers of financial service providers are generally in possession of far less material and important information about a product than the advisers recommending it or the manufacturer providing it. Customers are reliant on the good conduct of providers and their intermediaries to sell them products appropriately and deal with them fairly.

[1]See page 5 for description of RFAs

Conflicted conduct can have a lasting impact on the customer on the other side of the deal, whether the conflict at the heart of a transaction is the result of conscious motivations, or of unconscious bias. Conflicts of interest that are not disclosed or managed appropriately are bad for customers.

Conflicted conduct and replacement business practices of financial advisers

Our primary concerns about replacement business practices are the poor outcomes for customers that can be driven by conflicted conduct. Advisers can earn significant upfront commissions – up to 230% of the first year's premium of a "new" or replacement policy – and other additional "bonus" incentives such as qualifying for overseas trips.

At the heart of our concerns is this established distribution model for the sale of insurance policies. The structure of this business model is based on the payment of commissions and incentives by providers to the advisers who sell their products. The upfront commissions that NZ providers are paying are high by international standards. The insurance providers and manufacturers must take responsibility for the consequences and risks attached to the incentives they offer. These incentives, that focus exclusively on sales volumes and targets rather than customer outcomes, are the drivers of the poor conduct we have discovered in our inquiries.

Our analysis of providers' data has shown a clear connection between the timing of replacement policies being sold and the incentives being offered. There is a strong link between types of commissions, the end of the clawback period (the period within which an adviser must pay back a portion of the commission if the policy is cancelled) and the likelihood of a policy being replaced[2].

Conflicted advice on the replacement of an insurance policy can lead to:

- poor customer outcomes and poor quality advice undermining confidence in market integrity
- claims being declined that might have been accepted under original policies
- benefits being lost that exist under original policies
- consumers being over-insured, or under-insured, due to poor advice
- policies that are cheaper in the short term being more expensive in the long term.

[2]See advisers' production analysis on page 11, and details in the 2016 report

An update on our continuing inquiries into replacement business activity

This report includes outcomes from the inquiries completed to date into 24 advisers selected for our review. This sample was selected due to concerns about potentially high levels of replacement business activity connected to incentives offered by insurance providers.

The 24 advisers comprised 17 registered financial advisers (RFAs) and seven authorised financial advisers (AFAs). This is because the vast majority of high replacement activity identified in our first report involved RFAs. Inquiries continue into some of these 24 individuals. The majority of the findings in this report refer to the activities of RFAs.

Key findings

- Half of the advisers we reviewed were either not aware of the obligation, under the Financial Advisers Act 2008, to exercise care, diligence and skill, or they were in breach of that obligation.
- Record-keeping is part of these requirements. Records of advice and conversations are essential to help clients make informed decisions and be able to understand the advice they are getting. We found that advisers in this review were poor at keeping records for the benefit of clients.
- Most of the advisers we reviewed and interviewed failed to recognise that incentives create a conflict with the interests of their clients.
- The industry – especially insurance providers – must take more care and responsibility for the outcomes and conduct that are driven by their sales incentives.

Background to our inquiries

This report is about how advisers respond to incentives that are offered for recommending and selling insurance products, and the process they have followed to advise their clients. It does not focus on the conduct or practices of providers that are offering the incentives.

We started our inquiries by looking for instances of replacement business advice where conflicted conduct, driven by incentives, raised questions about whether some advisers were acting solely in their own interests.

The current Financial Advisers Act 2008 (FA Act) regime is being overhauled by the Financial Services Legislation Amendment Bill (FSLA Bill), now before Parliament. The Ministry of Business, Innovation and Employment (MBIE) review of the FA Act in 2016 identified issues with the current regime, especially the inconsistent conduct and competency standards across different types of advisers.

Under the FA Act, RFAs can sell insurance with personalised advice. However, RFAs do not have to comply with a code of professional conduct that sets out minimum standards of ethical behaviour, client care, competence, knowledge and skills, and professional training. For an AFA, unlike an RFA, higher standards and a code of conduct apply. The first code standard is to place the interest of the client first.

AFAs and RFAs – what's the difference?

Different standards, obligations and regulations apply depending on whether an adviser is an authorised financial adviser or a registered financial adviser under the Financial Advisers Act 2008. For many RFAs involved in these inquiries it was their first interaction with the FMA.

- **AFAs —** are required to be individually authorised by the FMA to give advice that takes account of the client's individual situation on most types of investment products, including life insurance, as well as more complex products. They are required to abide by a code of professional conduct, including minimum education requirements. The code includes a requirement to place client interests first and act with integrity.
- **RFAs —** must register with the Registrar of Financial Service Providers, but are not required to meet the same standard as AFAs, such as minimum education requirements. They can give advice that takes into account a client's individual needs or requirements on life insurance, but not on more complex products such as KiwiSaver, bonds, shares, managed funds and derivatives. RFAs are not authorised by the FMA and are not subject to a code of conduct. RFAs are not obliged to actively disclose any qualifications or how they are remunerated, including whether they receive commissions or other incentives from financial product providers. However, RFAs are legally required to exercise 'care, diligence and skill' in carrying out their work.

Proposed changes to the law that are currently before Parliament would discard the RFA model and require all financial advisers to meet minimum standards of competence and conduct.

Therefore, with the majority of our inquiries focused on RFAs who have no obligation to a conduct code to put their clients first, there is no legal basis for determining whose interests were being prioritised when RFAs recommended replacing insurance policies.

The conduct obligation contained in section 33 of the FA Act applies to all advisers, regardless of their status as an RFA or AFA. Section 33 requires that an adviser, when providing a financial adviser service, must exercise the care, diligence and skill that a reasonable financial adviser would exercise in the same circumstances.

Breaches of section 33 are not an offence, so the tools available to the FMA to respond to conduct issues in relation to care, diligence and skill are the FMA's administrative powers. These powers include warnings and a direction in writing under section 49 of the FA Act. See our regulatory response guidelines.

The results of our inquiries

The majority of this report deals with outcomes from our inquiries into 17 RFAs. One AFA has received a compliance feedback letter as result of our reviews. Our inquiries into three additional AFAs continue[3].

So far as our resources allowed, we have reviewed conduct where we had the most concerns about the basis on which policies have been switched or replaced and the drivers for that activity. We particularly focused on incentives (of whatever form) provided by insurance providers. We do not consider this is a representative sample of all the RFAs selling insurance or the adviser population as a whole.

To date our inquiries have found that most advisers we reviewed were either not aware of the obligation under section 33 of the FA Act to exercise care, diligence and skill, or, in some cases, they were in breach of that obligation.

Advisers should also be aware that the obligation to exercise care, diligence and skill includes keeping good records of their advice and to record client communications, for the client's benefit, and provide these to the client to help them with their decision-making. Across many of the cases we reviewed client communications were poor and there was an absence of records to demonstrate that the adviser had met their care, diligence and skill requirements.

RFAs are not obliged to disclose how they are remunerated or whether there are any conflicts of interest when they are offering a product or service. This created a significant obstacle for us to conclude definitively that an RFA prioritised their own interest in receiving incentives over the interests of their clients.

[3]See table of summary of actions on page 12

While inadequate record-keeping for the benefit of clients falls short of the standard required under section 33, and is a breach of that section in itself, it also makes it difficult to assess the quality of the advice if there is no record of the advice provided.

We used the powers and tools available to us in these circumstances to determine the most appropriate regulatory response to breaches of the FA Act.

Warnings and compliance feedback

We decided that issuing warnings for these conduct obligation breaches was proportionate to the misconduct. We took into account our discussions with advisers and acknowledged that a breach of the care, diligence and skill obligation is not an offence under the FA Act. For these advisers this was also the first time the FMA had reviewed their conduct.

The message within these warnings is also relevant for the whole insurance sector. In future, where we find this poor conduct and unacceptable standards of client communication and record-keeping, we will take action and use stronger regulatory responses.

It was both striking and concerning that some of the RFAs we reviewed did not even recognise that conflicts of interest can arise from incentives and commission structures.

We also noted that the inconsistent standards in the current regime mean that there are insufficient controls on RFA conduct when it comes to managing conflicts of interest. This also points to the broader conduct issues that insurance providers are encouraging through the range of incentives they offer to advisers.

We look forward to the introduction of the new financial advice regime, as the consistent level of standards, disclosure and conduct proposed for all advisers in the FSLA Bill will help to address some of the issues in this report.

Next, we will focus our efforts on ensuring that advisers recognise their obligations to exercise care, diligence and skill, and maintain detailed records for clients. We also expect the industry as a whole to recognise the need to manage conflicts appropriately.

We are also looking at the insurance sales practices of qualifying financial entities (QFEs), which employ different incentives structures, to find out whether we see similar conduct concerns in that sector.

Our expectations for advisers

We expect all financial advisers to demonstrate:

- awareness and adherence to our guidance on care, diligence and skill
- they are explaining to clients the costs, benefits and consequences of replacing insurance policies
- how they have met their care, diligence and skill obligations. We expect to be shown how obligations have been met, not told that obligations were met
- they are meeting their compliance obligations by ensuring they have kept appropriate records of their client communications, and provide these records to clients in a way that can assist them with their decision making. We expect to be shown records of conversations and communications, not told they have taken place
- they have read the guide to the FMA's view of conduct that applies to licensed providers under the Financial Markets Conduct Act 2013 (FMC Act). While we acknowledge that this guide does not strictly apply to RFAs, as they are not licensed or authorised providers, we consider they should be aware of its contents.

We will be monitoring and measuring the conduct of advisers in dealing with clients by the care, diligence and skill they exercise and the quality of communications they deliver. Communications include both the conversations they have and the written advice they provide to clients.

We want advisers to understand the difference between a compliance 'product' and their conduct:

- A compliance product can assist advisers with their obligations by providing prompts, templates and processes designed to improve compliance
- An adviser's conduct obligation is the performance of a professional obligation requiring judgement, an appreciation of the needs of an individual client or transaction, and effective communication that will help the client to make a financial decision that is in their own best interest.

In general we were disappointed that among the advisers we reviewed there was a lack of awareness or recognition that receiving commissions and incentives to recommend products and hit sales targets was a conflict of interest.

Scope of the report

This report is the first time that we have focused on the individual sales and advice practices of a sample of RFAs and reported on the conduct issues discovered in our inquiries.

We have specifically focused on the conduct and practices of the intermediated sales of insurance by RFAs and AFAs. This is because there is a higher risk of unwarranted replacement business in this sector, which may not be in the interest of the client. These advisers, as opposed to QFE advisers, generally sell more than one brand of life insurance and maintain relationships with clients and providers that enable policies to be changed at intervals determined by commission windows.

The report does not focus on the conduct or practices of providers that are offering the incentives.

Other areas impacted by this report

MBIE completed a review of the current regime in 2016 which identified issues and areas for improvement, and the development of the FSLA Bill. The Bill is currently before select committee and is designed to improve access to quality advice for New Zealanders and promote the confident and informed participation of businesses, investors and consumers.

The government's review of the advice legislation did not recommend banning or restricting commissions, because it was determined that this might limit consumers' access to advice, and would not address conflicts of interest where financial products are sold through in-house distribution channels. However, the government suggested that the FMA and MBIE closely monitor conduct and the impact of the policy recommendations taken forward in this area.

Our inquiries show that the structure of the distribution model established by providers and manufacturers for selling insurance encourages poor practices and conflicted conduct among the advisers that sell their products.

Our inquiries into replacement business and conflicted conduct also reflect recommendations made by the International Monetary Fund in its 2017 Financial Sector Assessment Programme.

The IMF noted:

*"The life insurance sector is exposed to mortality and disability morbidity risks and **risks associated with commission paying practice** ...In addition there are risks associated with distribution practices in this market, where payment of high-levels of upfront commission to distributors has become prevalent. Insurers are exposed to lapse risk, where they are unable to recoup acquisition costs, while the apparent unsustainability of current commission practices (which the FMA is investigating) exposes life insurance companies to significant risk as practices eventually change".*

The IMF has identified issues and risks in the insurance sector and the need for stronger conduct standards for the insurance providers. In the absence of specific conduct regulation for insurance providers, we will continue to use our fair-dealing powers to respond to the issues we discover in the sector.

Currently, all the responsibility for managing conflicted conduct is loaded onto advisers by the insurance providers. For AFAs there are barriers and safeguards that promote management of conflicts and prioritise the interest of the clients, but without these safeguards for all advisers the risk of poor customer outcomes remains an ongoing concern.

We identified future work on commissions and the behaviour and practices of providers in our 2017/18 Annual Corporate Plan.
This includes exploratory work and thematic reviews into soft commissions and incentives, the replacement business practices of QFEs, and starting work on bank incentive structures.

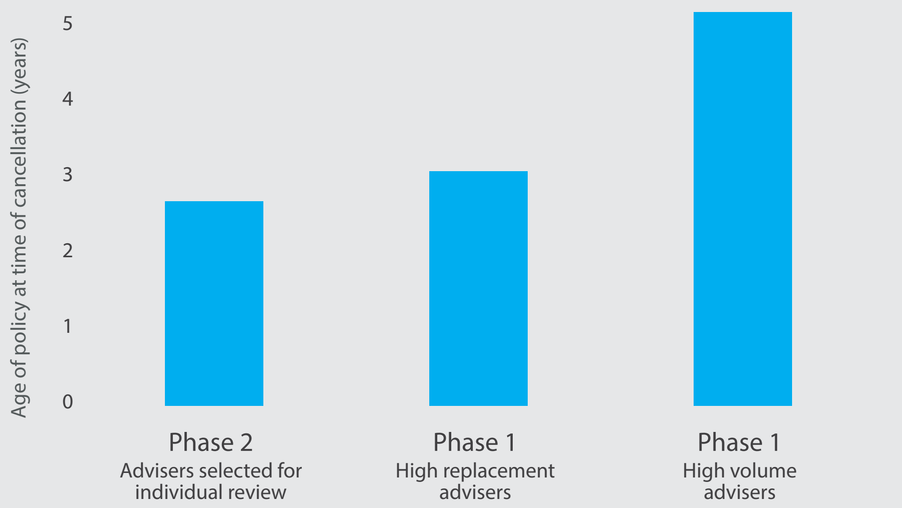
MBIE recently announced the terms of reference for the review of insurance contract law. This will include a review of the gaps in the regulation of insurers' conduct.

Selecting the sample of 24 advisers for review

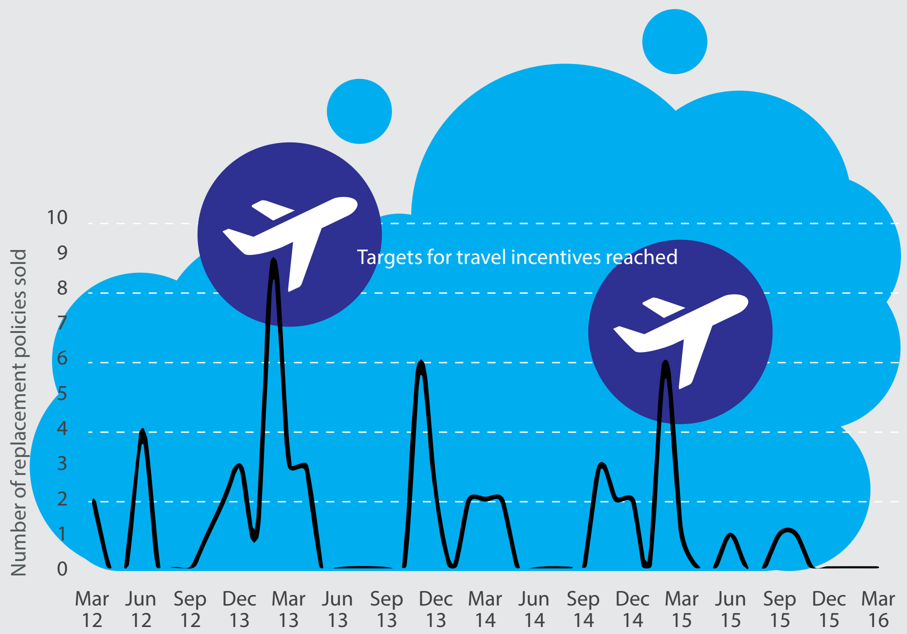
Phase 1 refers to findings and data in our 2016 report.
Phase 2 findings refer to analysis of that data among the 24 advisers in the sample for this report.

Showing age of policy when it is cancelled. Median age of policies was less than 3 years old among the 24 advisers selected for individual review.

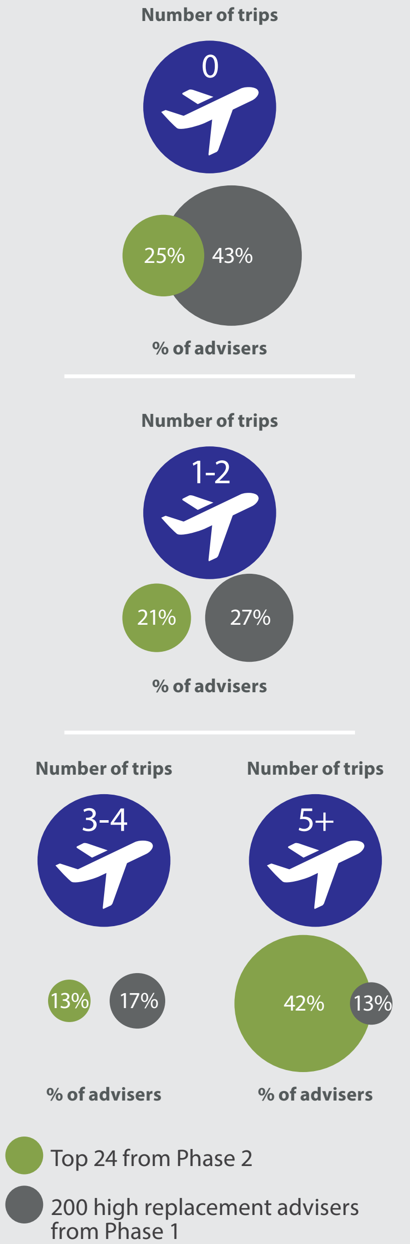
In Phase 1 of the review we collected policy data, including the start and end date of a policy and who sold the policy.



Timing of sales relative to overseas trip incentives received (one example)



Number of overseas trips taken in the sample of 24 cases in this report phase 2, compared to phase 1.



Criteria for analysing data and selecting 24 advisers for further review

The industry data examined in our 2016 report, Replacing life insurance – who benefits?[4], identified 200 advisers who had a high volume of new policies on their books and a high rate of lapsed business, as a proxy to identify potential replacement business.

We then reviewed that data[3] with reference to:

- the number of overseas trips taken by an adviser
- the volume of transactions within qualifying windows linked to incentives being offered
- any other complaints data or intelligence on file.

Based on this analysis, we requested further data from the 24 selected advisers including a sample of client files. See table: Summary of actions.

Summary of actions

Action	Subject of inquiries
7 AFAs and 17 RFAs selected for further individual analysis	24 advisers
Eliminated from inquiries where proportion of replacement activity dropped due to genuine new policies and unrelated lapsed policies	1 AFA, 5 RFAs
Removed due to poor health	1 RFA
Ongoing inquiries for other conduct reasons	2 RFAs
Deregistered from Financial Service Providers Register for reasons unrelated to our inquiries	1 AFA
Regulatory sanction or further investigation	10 RFAs, 4 AFAs (Client file reviews and/or interviews with advisers)
Private warnings	4 RFAs
Compliance letters – no further action	1 AFA, 6 RFAs
Ongoing inquiries into conduct	3 AFAs

The main focus of our inquiries was the 14 advisers selected for further individual reviews. These inquiries included collecting client files, desk-based reviews and in some cases interviews.

- 10 were RFAs.
- Four were AFAs. One AFA has received a compliance letter noting our concerns while indicating no further action on these matters.

[4]See page 20 of our 2016 report Replacing life insurance – who benefits?

Section 33, Financial Advisers Act – care, diligence and skill

We published examples online of how we consider the obligation to exercise care, diligence and skill applies to financial advisers, when providing advice on the replacement of insurance policies.

Our website states that:

"In general, when providing advice, advisers must:

- assess the product's suitability for the client's needs
- explain the key features and any limitations of the product to the client
- clearly articulate any limitations on the service being provided.

In addition, advisers should keep records demonstrating how they have fulfilled the care, diligence and skill requirement in providing advice, and how they have disclosed and managed any conflicts of interest arising from commissions or their remuneration. AFAs also have specific conduct and record-keeping requirements under the Code of Professional Conduct."

There are situations where an adviser decides to limit the scope of their advice so that they are not providing advice on the client's existing arrangements. If the adviser is not making a comparison of the client's existing arrangements with the new recommended product, the adviser should inform the client of the limited scope of the service. The adviser should explain that no comparison has been made, the types of adverse consequences which might occur as a result of changing products and that the specific consequences for the client have not been considered.

Advisers should keep records demonstrating how they have fulfilled the care, diligence and skill requirement in providing advice. Specific examples of how these requirements apply to insurance replacement advice are provided on our website. Advisers should ensure that advice and conversations are recorded and provided to clients to assist them with their decision-making.

What we found

We discovered instances where, under a limited scope of advice, an adviser could not show us they had fully explained the types of adverse consequences which might occur as a result of replacing an existing product with a replacement product and that the specific consequences for the client had not been considered. They had no records to demonstrate the service they had provided or documentation of communication with clients. The advisers simply gave assurances to us that this had happened.

This lack of recorded information for clients is compounded by that fact that RFAs have few disclosure requirements, particularly around disclosure of remuneration and conflicts of interest. As detailed in our guidance, keeping records is an essential part of their obligations under the FA Act, section 33.

These factors meant that we did not have the necessary information to definitively conclude that some advisers weren't acting in the interests of their clients, even while there was a connection between the timing of incentives received and sales targets being met through replacement activity.

Warnings issued

In four cases we decided to issue private warnings to RFAs that detailed our view that their conduct had breached their obligations under section 33 of the FA Act.

Three of the advisers who received warnings were limiting the scope of their advice by not making a comparison of client's existing arrangements with the new recommended product. The advisers told us they verbally explained or disclosed to clients that no comparison was being made, the types of adverse consequences that might occur as a result of changing products and that the specific consequences for the client had not been considered. However, we found that the failure of those advisers to make and maintain records of that advice and conversations for the benefit of clients was a contravention of section 33 of the FA Act.

One warning was issued to an adviser who was neither making appropriate comparisons of clients' existing arrangements with the new recommended product, nor limiting the scope of the advice. The adviser did not provide any explanations or records of the advice and conversations to assist clients.
A warning was considered appropriate in this instance as the adviser was exiting the industry.

Given that breaches of the care, diligence and skill obligation are not an offence under the FA Act, we decided that issuing warnings was the most proportionate response to these conduct obligation breaches. We instructed the advisers to strengthen and improve their practices.

We will retain all the materials generated as a result of these inquiries for assessing these advisers' ongoing compliance with financial markets legislation. We expect the industry to take notice of our concerns and take steps to fully understand the obligations to exercise care, diligence and skill when replacing insurance policies.

The regulatory response to the issues we found was based on the standards we consider are required to comply with section 33 of the FA Act. The private warnings are proportionate to this conduct because we could only apply our administrative powers to issue warnings or written directions for breaches of this section of the FA Act.

We remain concerned about the conflicted conduct that exists as a result of the incentives being offered for replacing policies. Care, diligence and skill is necessary but is not a sufficiently comprehensive test for managing, or a protection against, the potential damage from conflicts of interest.

The risk that clients' interests are not being well-served remains concerning because:

- there is no requirement for RFAs to disclose remuneration and conflicts of interest in the current regime
- our general finding of an absence of adequate record-keeping in the sample we reviewed.

Other action

During our review of advice files we also observed general inconsistencies in advisers' understanding and compliance with section 33.

In seven cases we provided compliance feedback to advisers identifying the areas that needed to be improved, having decided that no formal action was appropriate at this time.

There were consistent themes in these cases such as poor record-keeping, a lack of awareness of care, diligence and skill obligations and the need to manage conflicts.

- No records of product comparisons being provided where replacement business was a personalised service
- Some client files showed no evidence of disclosure statements being provided to clients
- Poor attention to needs analysis
- No evidence of scope of service agreed with clients
- Inconsistency in the client files being kept by the same adviser
- No records of the advice provided to clients
- Lack of oversight of advisers working in the same business.

Lessons for advisers

The compliance and conduct issues noted in our findings were not systematic across every file in the individual adviser files we reviewed. However, we saw consistent themes around professional standards and a lack of care, diligence and skill. Record-keeping is not a box-ticking exercise designed to satisfy the regulator that advisers have met their compliance obligations.

Keeping records is an integral part of the advice service, as it ensures that customer and client needs are being met. Care, diligence and skill means documenting advice services and providing these records to clients in a way that will help them make decisions.

When an adviser recommends that a client replaces an existing policy with a new one, they should consider whether they are giving an opinion (or whether the client might reasonably expect them to be giving an opinion) on the disposal of an existing product, as well as the purchase of a new product. The client may also naturally expect an adviser to be making comparisons and be able to inform them of the differences in cover between the existing policy and recommended new policy.

When advisers do not explain the adverse consequences that may result from limiting the scope of service, and do not provide comparisons then the consumer is at risk. The client assumes they have been given advice and recommendations that will best serve their needs. In these situations of misplaced consumer expectations it is likely that the consumer will be left with a problem that needs resolving, yet be ill-equipped and under-informed on how to resolve it.

Providing replacement advice and limiting the scope of service

We consider that, when providing personalised advice on the replacement of insurance products, a reasonable adviser would make an appropriate comparison of the client's existing arrangements and the new, recommended product. If no comparison is being made, the client needs to understand the implications of the limited scope of service.

Offering a limited advice service

If the advice service is limited and no comparisons are being made between the client's existing arrangements and the recommended product, the adviser should inform the client of the limited scope of service. The adviser should explain that no comparison is being made, the general types of adverse consequences which might occur as a result of changing products, and that the specific consequences for the client have not been considered.

The importance of record-keeping for determining compliance obligations are being met

In over half the cases we reviewed, the absence of records hindered our efforts to determine whether the advice being offered was in the client's interest or for the benefit of the adviser.

We note the judgment in the case of DIA v Ping An, in the Auckland High Court. The judge stated that the absence of records would lead the court to infer that compliance had not been taken seriously, and therefore the consequence of poor records was a further sign of poor compliance.

We will in future take a similar view to this high court judgment and infer breaches in conduct obligations are more likely to have occurred where there is a failure to comply with the obligation to keep records.

The risks for consumers

There will be occasions, such as saving on premiums, where it is in the interest of the client to change insurance providers. However, there are a number of risks associated with replacing a current policy, including:

- a reduction in cover, particularly with respect to exclusions; by replacing policies, consumers could lose benefits they might have received under the original policies
- non-disclosure risk – as the client goes through a new application process, there is the chance that they may overlook disclosing something. The follow-on risk is consumers could have claims declined that might have been accepted under their original policies
- stand-down periods during which certain claims will not be paid out for a specified period after the new policy is established
- the ongoing affordability of the new policy, particularly where the cost is a driver for the initial change of provider; policies that are cheaper in the short term can be far more expensive in the long term
- changing premiums could mean a consumer is paying for insurance they don't need.

There are also concerns around the differences in specific coverage and benefits between the old policy and the new policy:

- different policy exclusions – a consumer could have a medical condition that is excluded from the new policy
- new exclusions introduced when new policies are implemented, eg suicide exclusions 13-month stand-down
- differences in cover – a consumer may have a medical history of heart disease, but the new policy has less coronary cover
- a difference in the financial stability of the new insurer or reinsurer – a consumer may end up paying higher premiums, or find it harder to make claims
- a difference in consumer experience, services or claims processes – a consumer may find it harder to deal with their new insurer.

We are also concerned that if a client is impacted by one of the above factors, it is likely that they will not be aware of it until after they have implemented a proposed replacement solution and cancelled their previous cover. In these cases it is unlikely that they would be able to reinstate their previous cover on the same terms, which could mean the client is permanently disadvantaged.

Reform of the current regime

The Financial Services Legislation Amendment Bill

In July 2016, the Government agreed to the design of a new regulatory regime for the provision of financial advice in New Zealand. The new regime aims to improve access to quality financial advice while not imposing undue compliance costs on the industry or becoming a barrier to innovation.

In December 2017 the FSLA Bill had its first reading. This Bill gives effect to the new regulatory regime for financial advice and has been referred to the Economic Development, Science and Innovation Select Committee.

The requirements in the FA Act differ depending on the type of adviser, category of financial product, type of advice and type of service.
The regulatory responses available to us also vary depending on the type of adviser. The FSLA Bill repeals the FA Act and amends the FMC Act. Under the proposed amendments the distinction between RFA and AFA will no longer apply, nor will the distinction between class and personalised advice. Anyone who provides financial advice will need to be engaged by a financial advice provider and, if they wish to provide advice to retail clients, the provider will need to be licensed by the FMA.

Financial advice providers will be able to give financial advice directly (eg digital advice), through financial advisers, and/or through nominated representatives. Anyone who provides advice to retail clients will be required to meet the same standards in the FSLA Bill including the requirement to give priority to the client's interests and will be subject to a new Code of Conduct. The Code of Conduct will set minimum standards of competence, knowledge and skill, ethical behaviour, and client care.

Financial advice providers will be licensed under the FMC Act and the compliance and enforcement tools in the FMC Act, such as civil liability, and licensing actions such as censure and the imposition of action plans will apply. This will give us a wider range of regulatory responses and we will be able to refer all financial advisers to the Financial Advisers Disciplinary Committee.

Industry overview

Managing conflicts of interest

Conflicts of interest are inherent in the sales of most financial products, but particularly problematic in some parts of the insurance industry.

While this report does not include any findings about the practices of providers, personal insurance providers are currently encouraging high levels of switching or replacement. The providers and manufacturers are driving conflicted conduct by offering high levels of upfront commissions, attractive incentives, business development opportunities and transfer terms. The current sales model continues while the industry has yet to test alternative ways to distribute life insurance and address consumer needs in a way that is most appropriate for consumers.

Financial advisers in the current structure are motivated by the remuneration rewards offered for completing sales. In the case of RFAs the risks of conflicted conduct are not counterbalanced with appropriate conduct obligations designed to encourage professionalism and good client outcomes.

The commission model for distribution creates conflict risks that must be carefully and properly managed by the adviser. Because RFAs are not currently required to disclose how they are remunerated and are not subject to the obligations of the code of conduct, the control factors that help mitigate these risks for AFAs do not exist for the vast majority of advisers selling life insurance – RFAs.

While this report focuses on the state of conduct we saw in the adviser space, insurance providers need to take responsibility for mitigating areas of poor and conflicted conduct, since it is the incentive and commission structures they have designed that create these conflicts. In Australia, this has been recognised by the industry, which has acted to re-calibrate incentive structures around life insurance. New Zealand providers have noted these issues in dialogue with us, but they have yet to implement any solutions.

As part of our response to the IMF recommendations around the regulation of conduct in the insurance industry, we will also consider how fair-dealing provisions in the FMC Act apply to the sale of insurance products where appropriate.

We expect that any incentives providers offer to advisers should be aligned to customer interests and better customer outcomes, rather than focusing on sales volumes and targets.

Future focus

Our Annual Corporate Plan sets out our ongoing work in relation to conflicted conduct, soft commissions/incentives and sales practices in vertically integrated businesses. This work is all scheduled to be completed or commenced in 2018.

Further thematic reviews into conflicted conduct and commission structures

- The use of soft commissions and incentives structures by insurance providers
- QFE management practices for replacement business
- Bank incentive structures – how incentives are managed in vertically integrated businesses

Engaging with other agencies and industry bodies

Developing supervision and licensing frameworks

- While the new code of conduct and legislative process is finalised we will be establishing our licensing and supervision frameworks for advisers under the new regime
- Intelligence gathered from our inquiries and monitoring to date will be carried over to the new licensing arrangements

Updating the examples on care, diligence and skill on the FMA website

- We are considering making some changes to the care, diligence and skill web page in light of the findings in this report.

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