Strategic Risk Outlook

2019

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

Contents

Part 1

Introduction

About the SRO

The Strategic Risk Outlook (SRO) provides our medium-term view (three to five years) of the most significant risks to and opportunities for promoting fair, efficient and transparent financial markets.

Our purpose and approach

The FMA is an independent Crown entity and New Zealand's principal conduct regulator of financial markets. Our overarching statutory purpose is to promote and facilitate the development of **fair, efficient and transparent financial markets**.

Financial markets means not only traded markets in securities but the broader market for financial services and products.

Fair means providers and participants acting fairly and professionally, and focusing on serving the needs of customers*.

Efficient means dynamic and accessible markets that facilitate growth and innovation.

Transparent means investors and customers get the clear, concise and effective information they need to make informed decisions.

We also want to see capable and engaged investors and customers.

We expect that fair, efficient and transparent financial markets will promote high levels of trust and confidence.

There are many factors that contribute to achieving our statutory objectives. Working within our statutory framework, our role is twofold.

First, we seek to promote and facilitate developments that enhance fairness, efficiency and transparency in financial markets by working and engaging with industry, investors and customers.

Second, we seek to identify and mitigate risks to achieving these conditions. We do this by:

- setting expectations and influencing industry behaviour
- monitoring adherence to regulatory and legislative requirements
- identifying breaches and taking action
- working to enhance investor and customer engagement and capability.

* Serving the needs of customers

This means financial service providers focus on:

- treating customers fairly in all interactions
- recognising and prioritising the interests of customers and effectively managing the conflicts of interest that arise
- giving customers clear, concise and effective information
- designing and distributing products that are suitable, work as expected and as represented, and are targeted at appropriate customer groups
- ensuring adequate after-sales care, including complaints and claims handling, and not imposing unnecessary barriers to switching or exiting a product or service
- effectively monitoring their own conduct, and where relevant the conduct of suppliers and distributors, to ensure they can identify, rectify and learn from mistakes.

FMA's regulatory approach

The following principles underpin our regulatory approach and guide our regulatory decisions.

- **Conduct regulator**: we focus on protecting investors, customers and the integrity of markets through influencing how participants behave towards their customers, investors and each other.
- **Intelligence-led and harm-based**: we use intelligence to identify and assess the areas of greatest harm to investors, customers and financial markets, and the drivers of that harm.
- **Outcome-focused**: we focus our resources on where we have the greatest opportunity of achieving desired outcomes and reducing harm. We consider the most appropriate action for each situation, recognising the limits of our powers, and considering regulatory burden and potential unintended consequences of our actions.
- **Effective and efficient**: we regularly review the use of our resources to enhance our effectiveness and efficiency.
- **Consistent and transparent**: we clearly communicate our intentions and expectations to market participants, and explain our actions.
- **Flexible and responsive**: we have an operating model that enables us to adapt and respond quickly to changing market conditions. We seek and act on feedback, and learn from our experiences.
- **A systems view**: we promote an integrated and coordinated approach to financial markets regulation in New Zealand.

Financial markets regulation

New Zealand's financial markets regulatory system reflects the twin peaks model of conduct and prudential regulation. The FMA is the principal conduct regulator. The Reserve Bank of New Zealand (RBNZ) is the prudential regulator, and is responsible for promoting the maintenance of a sound and efficient financial system.

We work with a number of other agencies that support the functioning of the system. These include:

- the Ministry of Business, Innovation and Employment (MBIE), which develops financial conduct regulation policy and advises the Government on relevant issues
- the Commerce Commission, which enforces laws relating to competition, fair trading and consumer credit contracts
- the Commission for Financial Capability, which works to improve financial capability of New Zealanders
- the Serious Fraud Office, which prosecutes cases of serious fraud or complex financial crime
- the Department of Internal Affairs, which enforces AML/CFT requirements for designated non-financial businesses.

The FMA is a member of the Council of Financial Regulators (CoFR), together with the RBNZ, MBIE, Treasury and the Commerce Commission. CoFR provides a forum for a continuous, forward-looking focus on system risks and regulatory coordination by members[1]. The 2018/2019 Conduct and Culture reviews, which were jointly carried out by the FMA and RBNZ, were a clear demonstration of agencies working together to understand and address system-wide risks.

Our sector view framework

This SRO is based on our sector view framework. We use this framework to identify and respond to regulatory risks. In assessing risks, we focus on the risk of harm to investors and customers, and risks to the integrity of New Zealand's financial markets. The sector view framework allows us to build an understanding of sectors we regulate and how they are changing, as well as identify areas of current and potential concern. We then compare and prioritise these areas and target our activity accordingly.

More detail on this process is provided in the appendix.

This document has two parts. Part 1 provides a high-level summary of our findings. Part 2 provides more detail of our analysis

The sector view process

1. Define and understand the sector
2. Identify trends and developments in the sector (environmental scanning)
3. Assess the sector using a standardised framework built on the attributes of a well-functioning market
4. Identify trends and developments, sector and cross-sector risks, long-term opportunities and challenges, and sector outcomes
5. Determine strategic priorities, to drive business planning and inform decision-making

Other related documents

Our Annual Corporate Plan builds on the SRO, outlining activities for the coming year that will promote our strategic priorities, address regulatory risks and deliver sector outcomes. Our Statement of Performance Expectations, Statement of Intent (SOI), and Annual Report together outline how we are performing against these priorities and other measures.

We will be updating our SOI in 2020 to reflect the revised strategic priorities highlighted in this document.

Let us know what you think

If you would like to share your views on our SRO or have any questions, please get in touch with us at questions@fma.govt.nz

Sector risk profile

Our sector risk profile highlights what we see as the most significant cross-sector and sector-specific risks, as well as the major opportunities and challenges to delivering fair, efficient and transparent financial markets.

Cross-sector risks may drive harm across some or all sectors. Sector-specific risks relate to individual sectors. Opportunities and challenges represent major drivers of change that may increase or decrease risks, which we will monitor to determine if further action is necessary.

Cross-sector risks

Governance and culture – weak governance, culture, and systems and controls at listed entities and financial service and product providers increases the likelihood of harm to customers and undermines confidence in markets.

Incentives and conflicted conduct – incentive structures and practices that create conflicts of interest that may drive misconduct if not effectively managed.

Investor and customer engagement and capability – low investor engagement and understanding may lead to the uptake of unsuitable products or inappropriate investment decisions, resulting in poor long-term outcomes.

Anti-money laundering – entities fail to meet Anti-Money Laundering/Countering the Financing of Terrorism obligations, which undermines confidence in markets.

Perimeter – unlicensed entities undertake regulated activity, entities register on the Financial Service Providers Register (FSPR) without intending to offer services here, or entities offer services into foreign jurisdictions illegally.

Sector risks

Capital Markets

Disclosure, and financial and non-financial reporting of listed issuers – inadequate, incorrect or misleading disclosure and/or poor-quality financial or non-financial statement information and reporting.

Trading misconduct – participants failing to act with honesty and integrity, including participating in or facilitating insider trading and market manipulation.

Confidence in auditing – poor audit quality (or the perception of poor quality) undermining investor confidence and leading to disclosure failings.

Stability of market infrastructure – the risk to market confidence of a significant or prolonged outage of a key piece of market infrastructure.

Investment Management

Fees and charges – high and/or complex fees and charges that are not reasonable and commensurate.

Stability of funds – Managed Investment Scheme (MIS) managers have insufficient processes and controls to respond to a liquidity crisis event, which could lead to investor losses.

Product suitability – poor product design, insufficient or ineffective disclosure of risks, costs or strategies, particularly for complex products, resulting in investors holding unsuitable products.

Supervisors' capacity and capability – a lack of resource and proactive monitoring, risk identification maturity and capability could undermine effective frontline regulatory oversight by supervisors.

Sales, Advice and Distribution

Sales and advice processes and practices – sales and advice processes and practices are not aligned to the needs of customers.

Scams and fraud – investors are subject to frauds and scams.

Banking and Insurance

Systems and controls – inadequate systems, controls and processes for identifying, managing and reporting misconduct.

Product suitability – insufficient consideration of customer needs in the design and ongoing performance of products.

Remediation of conduct issues – remediation is too slow or insufficient, and lacks senior management focus.

Technology and business transformation risks – IT system constraints, underinvestment, reliance on manual processes, poor implementation and consistency in system use, and the rise of cyber-threats.

Remit risks – absence of conduct powers and therefore FMA regulatory oversight in relation to banking and insurance.

Longer-term opportunities and challenges

Our assessment also identified a number of longer-term opportunities and challenges for promoting fair, efficient and transparent financial markets. We will monitor these trends and act where necessary to mitigate emerging risks and pursue opportunities, although some of these may be beyond our direct influence.

Regulatory and legislative change – there is a significant body of financial markets policy work in progress in New Zealand, aimed at increasing protection and enhancing outcomes for investors and customers. This work is likely to drive changes to market structure, business models and firm behaviour, and may present implementation and transition risks in addition to benefits.

Innovation – innovation can provide New Zealanders with better, cheaper, and more convenient access to financial services and products. Innovation can also challenge regulatory protections and frameworks, and can expose customers or markets to risks. We seek to facilitate innovation in financial markets while safeguarding investor and customer interests.

The impact of climate change and other ESG[2] factors on financial markets – climate change and other ESG considerations are driving change in financial markets on a number of fronts. There are opportunities for development of new green and socially responsible products and services, and greater customer choice. A growing interest in these products and services has led to ongoing development of associated monitoring and reporting frameworks. There are also risks and challenges, such as the emergence of stranded assets[3], and the impact of changing pricing of products (eg the cost of insuring assets in areas prone to climate risks).

Demographic change – trends such as an ageing population, the growing influence of the millennial generation and growth in minority communities are likely to drive new products and ways of accessing financial products and services. These trends may also give rise to new pockets of vulnerable customers.

Confidence in the long-term sustainability and growth of New Zealand's capital markets – regulatory settings, market structure and poor behaviour could undermine long-term market growth and integrity. Capital Markets 2029 (see page 13) may identify barriers, or changes to promote health and confidence in capital markets.

Outsourcing – this is prevalent across financial markets, including outsourcing to non-licensed providers. It includes outsourcing of fund management (through fund-of-fund structures) and custody, and the use of wrap platforms[4] by advisers. Outsourcing can lead to specialisation and efficiencies, but may also present concentration and stability risks, and challenges for firms and regulators in maintaining oversight of risks.

Value for money – high fees that are not commensurate with the services offered or value provided, along with the difficulty of comparing products and services (including the quality of service), raise issues around value for money across a number of sectors.

Strategic priorities

Based on the risks and opportunities identified in the sector risk profile, we have identified the following strategic priorities. These, along with the principles that govern our approach to regulation, help us focus activity and allocate resources.

Governance, culture, systems and controls

Regulated firms exhibit a customer-centric culture that serves the needs of customers. In particular, firms have appropriate governance, incentive structures, sales and advice processes, and systems to manage conduct risk.

Credible deterrence of misconduct

We deter misconduct through effective enforcement action, particularly in relation to trading misconduct (eg insider trading and market manipulation), misconduct on our perimeter, failure to meet AML/CFT requirements, and misleading and deceptive conduct (ie enforcing fair dealing provisions of the Financial Markets Conduct Act 2013).

Successful implementation of potential remit changes

We deliver policy objectives while minimising transitional costs to firms and risks to customers – particularly in relation to the Financial Services Legislation Amendment Act (FSLAA) and potential changes to the conduct regulation of banking and insurance.

Investor and customer decision-making

Investors and customers are engaged and make active choices based on clear, concise and effective information.

Promoting trust and confidence in capital markets

Through improved quality of audit, disclosure and financial reporting, and effective oversight of NZX and other licensed capital-raising platforms.

Sector map

Our first step for identifying strategic risks is to segment the regulatory landscape into sectors. These sectors provide the basis for our assessment. The map below outlines these sectors and describes some of the activities and product types covered. The extent of our oversight varies across these sectors.

Capital Markets

Enables matching of issuers with investors, and creation and trading of securities

- Issuers
- Brokers**
- Trading venues (eg financial product markets such as NZX)
- Alternative capital raising (eg peer-to-peer and crowdfunding)
- Audit
- Market infrastructure (eg settlement systems)

Sales, Advice and Distribution

Enables distribution of products on an advised or sales basis, or directly through online platforms

- Qualifying Financial Entities (QFEs)
- Advisers*
- Derivatives issuers
- Retail platforms, aggregators (eg foreign exchange providers)

Investment Management

Provides investment vehicles and services to enable investors to seek returns on capital

- Retail funds, KiwiSaver, superannuation etc
- Wholesale funds
- Supervisors and licensed independent trustees
- Discretionary investment management services (DIMS)
- Custodians**

Insurance

Provides risk management functions for both individuals and businesses

- Life insurance
- Health and disability insurance
- General insurance

Banking

Provides access to deposit taking, payment services, and lending facilities (both secured and unsecured)

- Deposit taking
- Payment services
- Mortgages
- Overdrafts
- Credit cards
- Personal loans

Key:
- Direct regulatory relationship with FMA
- Indirect regulatory relationship with FMA

*Authorised Financial Advisers (AFAs), Registered Financial Advisers (RFAs), Qualifying Financial Entity (QFE) advisers, and, under the new regime, Financial Advice Providers.

**Brokers and custodians are supervised by the FMA under the AML/CFT regime.

Cross-sector drivers of change

These drivers of change reflect international and local developments, and drive both risks and opportunities across all sectors. They provide the overarching environmental context within which we undertake our sector assessment and risk identification.

Macro-economic conditions

The New Zealand and global economy has experienced a significant period of strong economic growth over the last decade. In its May 2019 Financial Stability Report, the RBNZ noted that while the New Zealand financial system is resilient, there has been a slowing in domestic and global growth, partly related to trade uncertainty. This has the potential to reduce investment returns and increase volatility. Over the longer term, indebtedness of some New Zealand households and dairy farms, and high debt levels and asset prices globally could present tail risk[5, 6]. Any significant easing of economic growth and/or market volatility may test the New Zealand investment community, particularly retail investors, who have become accustomed to year-on-year growth in recent years.

Demographic change

New Zealand is experiencing unprecedented demographic change, with an ageing population[7], increasing ethnic diversity[8] and growth of minority populations. This will drive change in the needs and expectations of customers and see firms develop new financial products and services to target specific groups and financial needs. In addition to the opportunities and risks associated with changing demand, and new products and services, these trends may give rise to additional pockets of vulnerable customers.

Climate change

Governments, markets, firms and investors are increasingly grappling with how to respond to climate change. New Zealand has committed to making substantial reductions in its greenhouse gas emissions through the 2015 Paris Agreement[9]. Climate change and the transition to a low-carbon economy will affect financial services in a number of ways. It will require increased efforts to identify and price risks associated with climate change, eg the cost of carbon, or insurance. This will affect the value of certain assets, and some assets may become stranded. Industry, policy-makers and regulators will need to work together to develop reporting and monitoring frameworks to support effective asset pricing, assessment and transparency of risks, and mitigate risks to customers and markets of a transition to a low-carbon economy. Climate change is also likely to give rise to greater demand for green-related financial products and services. We are conscious of the need to work with industry and consumers to ensure the regulatory regime facilitates these opportunities while managing the risks.

Technology and innovation

A number of technological developments are shaping the future of financial markets. These include:

- the rise of 'big data', eg increased risk-based profiling of consumers

- application of artificial intelligence, eg algorithmic trading and digital advice
- distributed ledger technology, eg crypto-assets, and clearing and settlement technologies
- access and use of personal data, eg open banking and finance.

These will drive new products and efficiencies but also potential risks to customers, including those associated with mis-selling, poor investor decision-making, trading errors and cyber-resilience. The ongoing challenge is to effectively facilitate innovation that improves customer outcomes, while ensuring the appropriate degree of protection for customers and maintaining market integrity.

Emergence and development of conduct regulation internationally

Since the Global Financial Crisis, regulators have increasingly focused on the conduct and culture of financial institutions. This shift recognises the limits of disclosure and transparency in providing sufficient customer protection. Some jurisdictions have introduced product design requirements, additional regulatory powers to ban or restrict the sale of high-risk products, and bans on commissions and incentives to strengthen protections during product distribution. The accountability and liability of senior managers has been enhanced, to incentivise sound management of conduct risks. Requirements to reduce trading activity risks have been introduced, including derivative margin requirements, and licensing and authorisation of financial benchmarks, credit rating agencies, central counterparty clearing houses, high-frequency traders and others.

While globally the financial policy reform agenda seems to be moving to a period of consolidation, in New Zealand a wide programme of legislative reform continues. This ranges from the implementation of a new financial advice regime to the potential introduction of increased conduct regulation for banks and insurers.

In addition, in 2019-20 New Zealand's AML/CFT policies and practices will be evaluated by the Financial Action Task Force, which may result in recommendations for changes in policy or monitoring approaches.

Trust and confidence

Despite the development of conduct regulation, poor conduct and disregard for compliance with the law (often by major financial players) has undermined trust in financial markets in some jurisdictions, most notably highlighted by the Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry[10]. This erosion of trust has culminated in calls for fundamental cultural change within financial institutions, and the prioritisation of customer-centric outcomes.

The remainder of this document summarises our assessment of the sectors. This includes an outline of the key trends, risks, opportunities and challenges, as well as the subsequent outcomes we will work towards achieving over the coming years.

Capital Markets

Overview of the sector

The sector covers both primary and secondary debt and equity markets. It includes alternative capital-raising markets such as equity crowdfunding, peer-to-peer lending, and innovative offerings. The sector fulfils a broad range of financial needs, including:

- capital raising
- managing investment, financial and other risks
- trading of securities, clearing and settlement
- providing investment opportunities.

Resilient and dynamic capital markets with broad investor participation and sound infrastructure play a fundamental role in supporting New Zealand's economy.

Outcomes sought

Based on the risks and long-term opportunities and challenges, we have identified the following sector outcomes to work towards.

Accessible, resilient and dynamic capital markets, where participants have a high degree of trust and confidence. This will be achieved through:

- improved quality and confidence in corporate disclosure, financial reporting and audit
- high standards of corporate governance
- a regulatory regime that reflects best practice in facilitating innovation where it can benefit investors or customers
- effective deterrence of trading misconduct.

Trends and developments

Primary markets

Headline metrics highlight a prolonged period of growth in New Zealand's public capital markets. A total of $9.5 billion[11] in capital was raised in 2018, an increase of 10% from the previous year. At the end of 2018, equity, debt and fund markets had a total market capitalisation of $164 billion[12]. The debt market has experienced solid growth, with the NZX Debt Market capitalisation growing to $31 billion in 2018 (an increase of 17%[13]), although the majority of corporate wholesale debt remains unlisted.

Despite growth in capital raised and market capitalisation, in recent years the number of issuers on the NZX Main Board has declined and the number of IPOs has been low, with only one in 2017 and none in 2018. The NZX remains top-heavy, with the NZX10 making up around 40% of the main board's total market capitalisation.

In response to concerns around the overall depth and breadth of our capital markets, the FMA and NZX have commissioned the industry-led project Capital Markets 2029. The project is due to report in the third quarter of 2019[14].

While the issuance of IPOs has stalled, the size of exchange-traded funds (ETFs) continues to grow. ETFs listed on the NZX now manage over $3.2 billion[15]. This represents a broader global trend in the rise of passive investment strategies (see page 18).

In the unlisted space, New Zealand start-up investment has more than doubled in the last decade[16]. However, concerns remain about the lack of companies looking to go on to list on public markets. Alternative capital raising through crowdfunding remains small – around $25 million in 2018[17]. As at May 2019, the USX (Unlisted Securities Exchange) alternative market had a capitalisation of around $2.8 billion[18].

Over the last few years we have received queries from a number of entities interested in launching initial coin offerings (ICOs) in New Zealand. However, there has not yet been a regulated offer of crypto-assets in New Zealand. To promote best regulatory practice, we have engaged with overseas regulators about their approach to crypto-assets and ICOs.

The recent hack and theft from a New Zealand-based crypto-asset exchange, and fraud and scam concerns related to crypto-assets highlight the risks associated with this area.

The FMA receives regular complaints about scams posing as crypto-asset opportunities, which are often global in nature. In response we have published warnings and alerts.

Secondary markets

The total value traded across NZX's cash markets for 2018 was $38.2 billion[19]. Algorithmic trading, and in particular high-frequency trading, is becoming more prevalent in the New Zealand

NZX market capitalisation

Source: NZX Shareholder metrics

market. This has led to an increase in the number of trades, and a reduction in their average value. Algorithmic trading increased from 17% of on-market trades in 2015 to 47% as at the end of Q3 2018[20]. This resulted in an increase in on-market trading to 53.4% of total value traded in 2018, a 27.4% increase from the previous year[21]. In part, this was driven by NZX's strategic review, which resulted in changes to the listing rules. The review also resulted in the decision to move to a single equity board in July 2019.

NZX has advised it will continue to focus on trends related to algorithmic trading during 2019, particularly:

- the impact of algorithms in the market close/closing auction
- the adequacy of risk management arrangements at participant firms
- the development of guidance on Direct Market Access (DMA) trading in NZX markets.

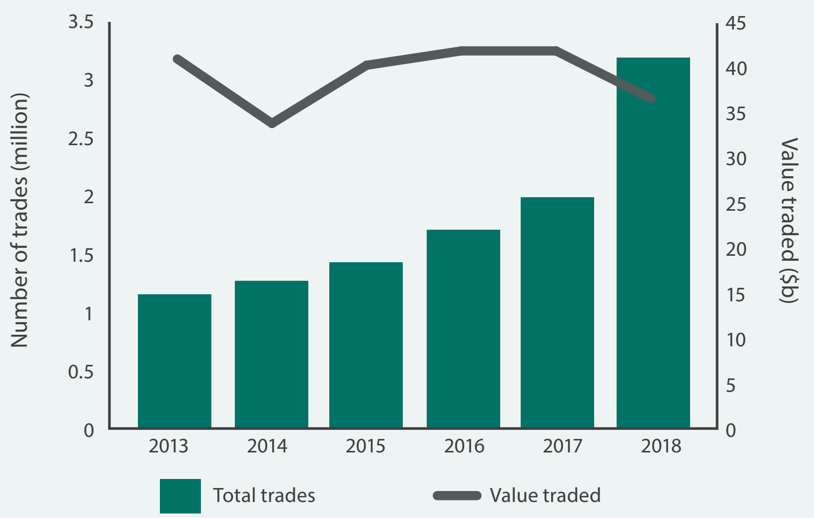
We support NZX's initiatives and its preparedness for market developments.

Despite the increase in trading volumes, the broking market (ie trading and clearing participants of NZX) remains concentrated, with nine participants as at June 2019[22]. Globally, there are concerns about the ongoing economics of equity broking, with firms increasingly relying on the provision of diversified services[23].

On the regulatory front, we have

Total equity transactions

Source: NZX Shareholder metrics



been active in investigating and pursuing cases of trading misconduct in recent years. In 2017 the FMA was successful in its first prosecution of a market manipulation case. We subsequently engaged with market participants about the lessons from this case, and released the findings from our investigation of the associated trading. In April 2019, we secured an enforceable undertaking relating to an admission of insider trading.

We have also been working with the RBNZ to review the regulation of clearing and settlement. The Financial Markets Infrastructure Bill will establish a new regulatory regime for financial market infrastructures.

Listed issuers and FMC reporting entities

2018 saw a number of high-profile corporate governance and disclosure failures. Our work has highlighted concerns with information flows between management and boards.

Corporate failings in a number of jurisdictions around the world have also raised concerns about confidence in audits and audit firms[24]. A recent FMA survey of investors, directors, managers and auditors has identified reasonable levels of confidence in audit quality, but also a serious gap in the expectations of investors and what auditors are delivering[25].

Growing recognition of the potential impacts of climate change and responsible investing has raised questions about how these concepts may affect asset pricing, corporate disclosure, financial and non-financial reporting, market innovations and opportunities, investor expectations and directors' duties.

Assessment

Our assessment of the capital markets sector highlighted weaknesses associated with market structure and dynamics, which may be constraining capital-raising activity. These issues are a key driver of Capital Markets 2029. Our assessment also underscored the importance of:

- effective disclosure and financial reporting
- maintaining market integrity through effective regulation
- minimising the presence of market manipulation, insider trading and fraud.

From our assessment, we identified the following sector risks. These risks generally relate to the potential to undermine integrity and confidence in capital markets. They may reduce the willingness of investors or issuers to participate, and in some cases cause direct harm to investors.

Sector risks and harms we want to address

Governance and culture – ineffective corporate governance, poor culture in publicly listed companies and/or limited capacity and experience of directors.

Disclosure, and financial and non-financial reporting of listed issuers – inadequate, incorrect or misleading disclosure and/or poor-quality financial or non-financial statement information and reporting.

Trading misconduct – participants failing to act with honesty and integrity, including participating in or facilitating insider trading and market manipulation.

Confidence in auditing – poor audit quality (or the perception of poor quality) undermining investor confidence and leading to disclosure failings.

Stability of market infrastructure – the risk to market confidence of a significant or prolonged outage of a key piece of market infrastructure.

Long-term opportunities and challenges

Our assessment also identified a number of long-term opportunities and challenges that may increase or decrease risk.

Confidence in the long-term growth of New Zealand capital markets – market structure, behaviour or regulatory barriers can undermine the long-term sustainability, integrity and growth of capital markets. Many of these issues may be beyond the direct influence of regulation. Capital Markets 2029 may identify a number of issues to address or changes to promote health and confidence in New Zealand capital markets.

Impact of climate change – on asset pricing, financial reporting and disclosure, and financial markets more broadly.

Cyber and technology change – particularly algorithmic trading, driving efficiencies but also raising concerns around stability of markets and market infrastructure.

Policy and/or regulatory change – driving improvements in policy outcomes, but also changes to market structure, business models and behaviour, which may give rise to new risks and opportunities.

Investment Management

Overview of the sector

This sector focuses on the management of investor assets. This includes fund management (eg KiwiSaver), discretionary investment management, and associated support services such as custody and administration.

Although we only license retail fund managers and not wholesale, we recognise that wholesale and retail investment management are interdependent.

High-quality and professional investment management is critical for enabling investors to achieve their long-term savings goals.

Outcomes sought

Based on the risks and long-term opportunities and challenges, we have identified the following sector outcomes to work towards.

Efficient, stable and well-managed funds and services that prioritise customer-centric outcomes through:

- quality of service and value for money
- firms considering investor needs in product design and throughout the product lifecycle
- improved investor engagement, understanding and capability
- informed investor decision-making based on clear and relevant disclosure
- quality and proactive frontline supervision.

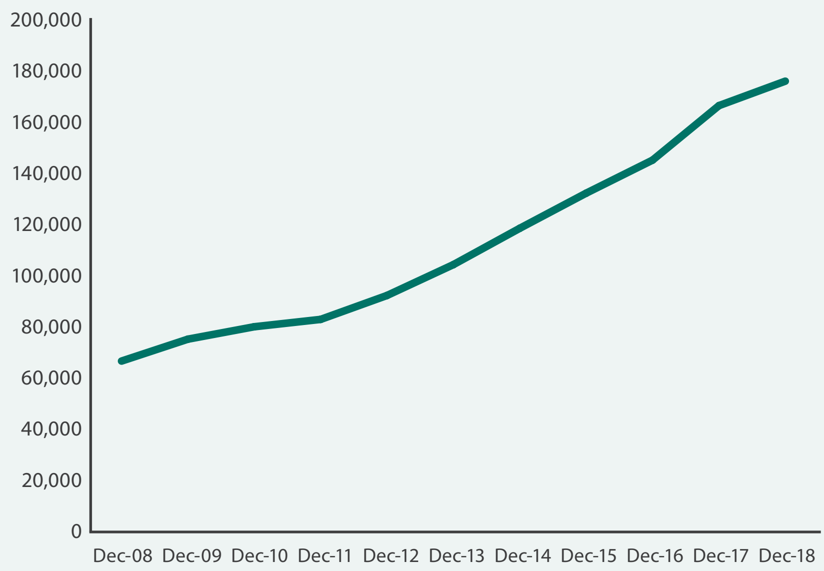
Trends and developments

Fund management

Funds under management continue to grow in New Zealand, with KiwiSaver expected to dominate future inflows. As at March 2019, there was an estimated $188 billion of funds under management (FUM) in New Zealand, including retail and wholesale managed portfolios[26]. As at March 2019, the KiwiSaver market had total estimated assets of over $56 billion[27], following a number of years of strong growth. The number of KiwiSaver members increased to 2.84 million in 2018.

New Zealand FUM growth 2008 - 2018 ($m)

Source: RBNZ



This number has grown steadily since 2016, with rises of between 4% and 5% year-on-year[28].

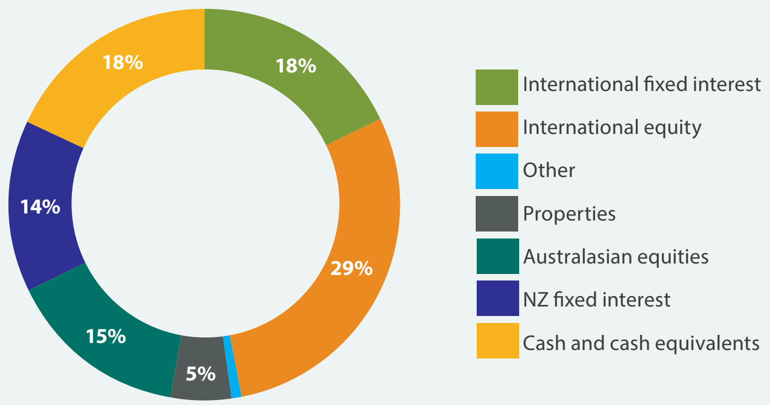
The nine KiwiSaver default scheme providers account for around 80% of market share by FUM[29].

KiwiSaver fund assets are diversified across New Zealand and international assets, and equities and fixed-income assets[30].

Both returns and fees have continued to grow. KiwiSaver investment returns have risen from $2.7 billion in March 2017 to $3.2 billion in March 2018 – an increase of 16.8%[31]. The average investment management fee paid by members in 2018 was $117. This is 19.1% more than the 2017 average of $98[32]. While the increase is not surprising given the increase in FUM, it also suggests that economies of scale are not driving fee reductions at this stage.

Where is KiwiSaver money invested?

Source: FMA 2018 KiwiSaver Annual Report

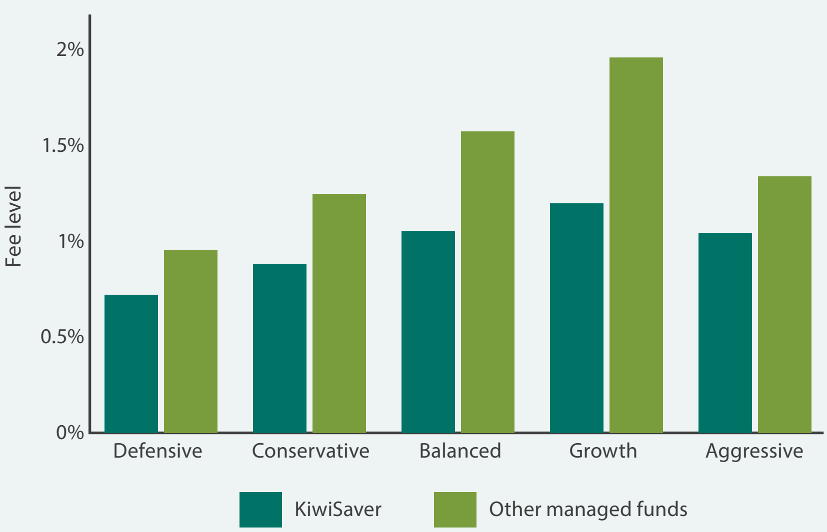


Growing public interest in fees has seen some new providers offering alternative fee structures.

Non-KiwiSaver fees generally remain significantly higher than comparable KiwiSaver fund categories.

Total fee comparison

Source: Disclose Data as at 31 March 2018



Concern has been raised both locally and internationally as to whether fee levels represent value for money from fund managers, particularly in relation to investment strategies and whether the fund is actively or passively managed. The Bank for International Settlements has estimated that passive strategies represent around 20% of assets under management globally[33].

The Asset Management Study, carried out by the UK's Financial Conduct Authority found weak price competition in a number of areas of the asset management industry, and no clear relationship between charges and the gross performance of retail active funds in the UK[34].

The Government has indicated fees will form part of the upcoming review of KiwiSaver default providers. Any changes as a result of this review, along with outcomes of other reviews, such as the Review of Retirement Income Policies, may also impact the sector.

More generally, implementation of the Asia Region Funds Passport in New Zealand may result in the entry of more international funds into the local market.

As noted in the Capital Markets sector, New Zealand has been part of the global trend towards increased ESG (including climate change) considerations in investment decision-making.

Finally, technology has the potential to drive significant change in the industry, with a number of distributed ledger technology initiatives related to administrative efficiency and algorithmic execution investment strategies being trialled globally.

Supervisors and independent trustees

As frontline regulators, supervisors and independent trustees play a critical role in the regulation of the sector. As at May 2019, six supervisors were licensed by the FMA. We have previously noted areas for improvement in governance, risk identification maturity and consistency of approach, which we will continue to engage with supervisors on.

Custodians

The custody industry is relatively small in New Zealand, and there is significant overlap with supervisor functions. The International Monetary Fund (IMF) noted in its 2017 Financial Sector Assessment Program (FSAP) review[35] that New Zealand is an outlier in not having a regime for the regulation of custodians. We are currently considering whether there is a case for recommending the establishment of a regulatory regime for custodians.

Assessment

Our assessment of the investment management sector highlighted specific issues around investor disengagement, particularly in relation to KiwiSaver default funds, fees and charges. International work highlighting the lack of a clear relationship between fees, performance, and therefore value for money. This may warrant further exploration in New Zealand.

Product complexity was also highlighted as a driver of risk. This increases the risks of mis-selling, as investors may not understand the key product features or risks to their investment goals.

We identified potential longer-term issues relating to outsourcing, including a lack of visibility of certain controls.

While we have seen improvement in supervisor capability, this is likely to remain an area of focus, particularly given the concentrated nature of the market.

DIMS (discretionary investment management services) is a sub-sector where we will look to advance our knowledge of the population through targeted monitoring and additional information gathering.

From our assessment, the following sector risks were identified. These risks generally relate to the harm associated with investors ending up with unsuitable and/or poor value investments and products.

Sector risks and harms we want to address

Fees and charges – high and/or complex fees and charges that are not reasonable and commensurate.

Investor and customer engagement and capability – low investor engagement and understanding may lead to the uptake of unsuitable products or inappropriate investment decisions, resulting in poor long-term outcomes.

Stability of funds – Managed Investment Scheme (MIS) managers have insufficient processes and controls to respond to a liquidity crisis event, which could lead to investor losses.

Product suitability – poor product design, insufficient or ineffective disclosure of risks, costs or strategies, particularly for complex products, resulting in investors holding unsuitable products.

Supervisors' capacity and capability – a lack of resource and proactive monitoring, risk identification maturity and capability could undermine effective frontline regulatory oversight by supervisors.

Long-term opportunities and challenges

Our assessment also identified a number of long-term opportunities and challenges that may increase or decrease risk.

Policy reforms – the impact of policy reforms aimed at improving outcomes in the sector, particularly in relation to KiwiSaver.

Outsourcing – prevalence of outsourcing of fund management and the lack of regulatory oversight in wholesale funds and custody arrangements mean that we may not have a clear view of some stability risks. Some of our concerns relate to smaller funds, which may lack sophisticated risk-management frameworks, and capability and capacity to manage outsourcing risks.

ESG and responsible investment – the growth of responsible investing opportunities, practices and associated ESG monitoring and reporting, as well as the potential impact on asset prices, including risks associated with stranded assets.

Custody – the outcome of our work assessing the case for regulating custody in New Zealand.

Sales, Advice and Distribution

Overview of the sector

Through the Sales, Advice and Distribution sector, retail customers access products such as investments and insurance on an advised or non-advised basis, including directly through online platforms.

Efficient and customer-centric sales, advice and distribution is essential for ensuring investors and customers end up with the right products to meet their financial needs.

Outcomes sought

Based on the risks and long-term opportunities and challenges, we have identified the following sector outcomes to work towards.

We want to see **sales, advice and distribution practices that protect and promote the interests of customers** through:

- a new advice regime that improves access to quality advice
- firms and advisers meeting the new advice requirements, and having sales and advice practices and remuneration structures that promote customer-centric outcomes
- credible regulatory deterrence of misconduct on the perimeter (including those offering unlicensed advice or other unregulated investment services).

Trends and developments

Authorised Financial Advisers	Registered Financial Advisers	Qualifying Financial Entities
1,800	7,000	53

Source: FMA QFE report, July 2018

Legislation, technology, and customer demand is driving change in this sector. These have the potential to improve access and outcomes for customers, but may give rise to new risks and issues.

Financial advisers

The key driver of developments in this sector over the next few years will be the introduction of the new financial advice regime. The Government's overarching objective with the reform of financial advice legislation is to improve access to high-quality financial advice for New Zealanders and establish a level playing field of regulation for all financial advisers.

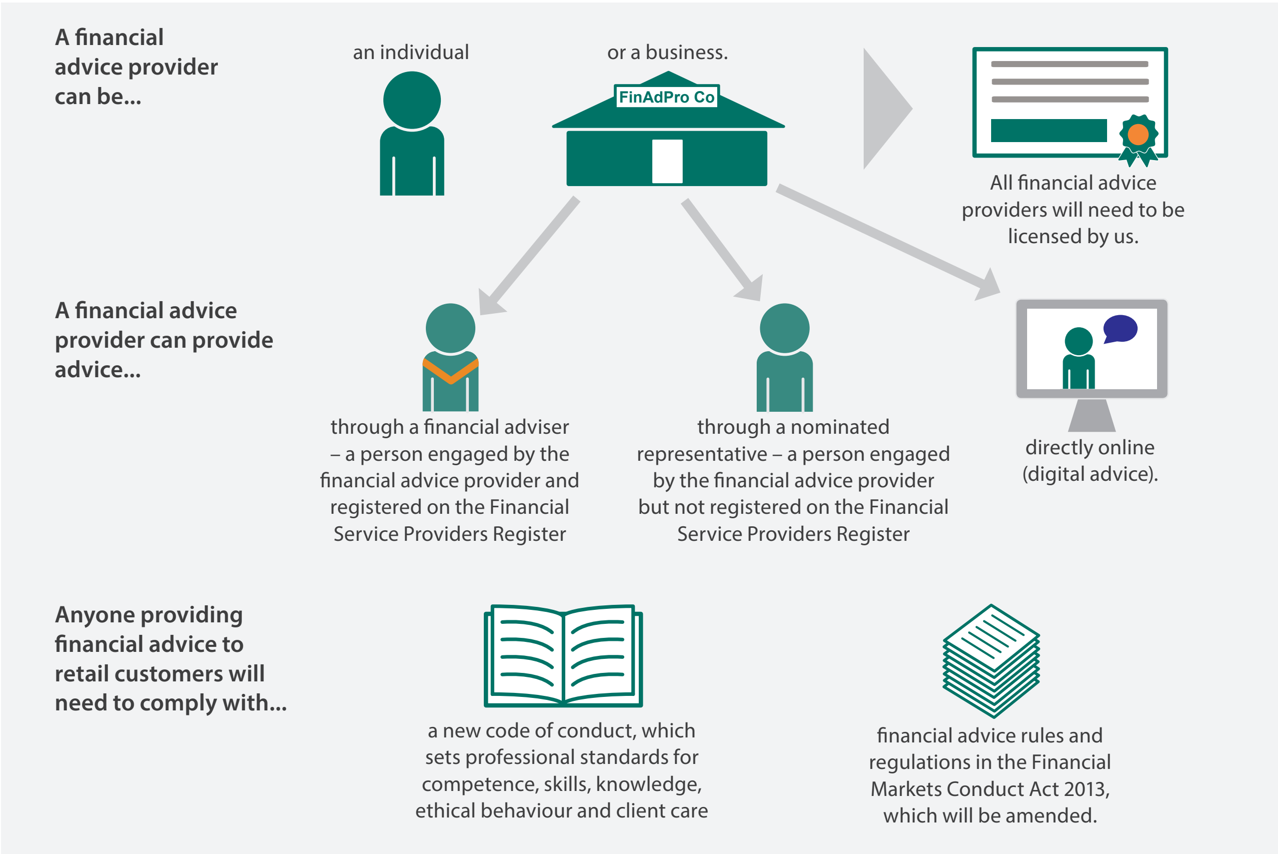
As the licensor and supervisor of financial advisers, we have a key role of working with the Government to ensure effective implementation of the new regime.

During and after the transitional licensing phase, there are likely to be changes to the structure of the advice market.

Another potential driver of change in this area is the continued rise

Under the new financial advice regime

Advice can only be provided by or on behalf of a **financial advice provider.**



of technology-based platforms that allow for online distribution. Existing examples include share-trading platforms.

Digital advice has the potential to provide customers with easily accessible and cost-effective financial advice. As at June 2019, we have issued seven exemptions to allow the development of digital advice services, though the concept has yet to reach critical mass in New Zealand.

Derivatives issuers

As at May 2019, we licensed more than 20 retail derivatives issuers (DIs). Derivatives can be used for speculation, hedging or arbitrage. The complexity of derivatives can drive risk, particularly where direct retail access and leveraged exposure are features. In response to these risks we have seen an increasingly interventionist approach from some of our regulatory peers, who are acting to ban or restrict the sale of high-risk products targeted at retail investors, such as contracts-for-difference and binary options[36].

More generally, greater ease of access to financial products through the internet has increased the risk of customers being exposed to frauds and scams. Netsafe noted a significant increase in 2018 in the reported value of losses from internet-based scams[37].

Anti-money laundering and countering the financing of terrorism

Under the AML/CFT regime, the FMA supervises around 800 reporting entities (REs), of which approximately two-thirds are financial advisers. The remainder are derivatives issuers, brokers and custodians, fund managers, providers of discretionary investment management services, equity crowdfunding and peer-to-peer lending platform providers, licensed supervisors and issuers of securities. The population therefore cuts across multiple sectors.

The regime has now been in place for five years, so we expect all reporting entities to be fully aware of their obligations, and to have adequate policies, procedures and controls to ensure compliance with the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 and its regulations. In our 2018 monitoring report we noted that although REs have made good progress in meeting their AML/CFT obligations, there are still a number of areas that require attention. This resulted in us issuing 18 formal warnings (including one public warning).

Assessment

Our previous monitoring and thematic work has identified concerns across a range of sales and advice providers, related to incentives, conflicts management, and systems and controls to manage conduct risk.

Our assessment of the sector highlighted the importance of monitoring the industry's response to the financial advice reforms – including changes to market structure, business models, and the capability and competence of advisers.

Retail distribution is the element of the value chain most associated with scams and frauds, including unlicensed entities undertaking activity that requires a licence.

The rise of online platforms and digital advice may raise new issues in terms of control and management of risks associated with algorithms and the potential for errors that impact large numbers of investors. It could also result in a reduction of the benefits associated with human interaction, including the opportunity for customers to have the risks and benefits of products and services explained.

Our upcoming thematic review of licensed derivative issuers will provide greater insights on the risks and harms in this area.

From our assessment, the following sector risks were identified. These risks generally relate to the harm associated with mis-selling, low investor engagement and understanding, and the potential to undermine market confidence and the reputation of New Zealand's financial markets.

Sector risks and harms we want to address

Governance and culture – weak governance and poor culture increasing the likelihood of mis-selling and harm to customers.

Sales and advice processes and practices – sales and advice processes and practices are not aligned to the needs of customers.

Incentives and conflicted conduct – inappropriate incentive structures and/or practices, poor disclosure of incentives to customers, and ineffective management of associated conflicts.

AML/CFT – entities fail to meet AML/CFT obligations, undermining confidence in New Zealand markets.

Perimeter – risks associated with unlicensed entities undertaking regulated activity; entities registering on the FSPR without intending to offer services here; or entities offering services into foreign jurisdictions illegally.

Investor and customer engagement and capability – low investor engagement and understanding may result in the uptake of unsuitable products or inappropriate investment decisions.

Scams and fraud – investors are subject to frauds and scams.

Long-term opportunities and challenges

Our assessment also identified a number of long-term opportunities and challenges that may increase or decrease risk

The impact of the new advice regime on the sector, including market structure and access to quality financial advice.

Increasing prevalence of digital advice and online platforms, and the associated technology and investor capability risks.

The potential rise of outsourcing practices, particularly involving unlicensed entities.

Banking and Insurance

Overview of the sector

While the banking and insurance sectors fulfil different financial needs, we have combined them for the purposes of this document. Retail banks and life insurers were the focus of the joint FMA and RBNZ Conduct and Culture reviews, and the risks and issues identified for each sector were largely similar.

Banking provides customers with access to deposit taking, payment services, and lending facilities (both secured and unsecured). Insurance provides risk management functions for both individuals and businesses.

The banking and insurance sector is critical for enabling customers to effectively participate in the economy and manage financial and other risks.

Banking and insurance are prudentially regulated by the RBNZ, while consumer credit and responsible lending legislation is enforced by the Commerce Commission.

It is important to note that neither banks nor insurers are licensed under the FMC Act and are therefore not covered by the FMA's monitoring and supervision framework at an overall entity level. The IMF FSAP review and the Conduct and Culture reviews highlighted the lack of entity-level conduct regulation for insurers and retail banks. We are working with the Government on addressing these gaps. In April 2019, MBIE released two options papers – one for its review of insurance contract law and the other on the conduct of financial institutions.

Outcomes sought

Based on the risks and long-term opportunities and challenges, we have identified the following sector outcomes to work towards.

Banks and insurers demonstrate how they serve customer needs through:

- appropriate governance, systems and controls for managing conduct risk
- design and management of incentive schemes that promote good customer outcomes
- appropriate prioritisation of remediation when things go wrong
- effective implementation of any new conduct regulation.

Trends and developments

Banking

There is significant market concentration, with the big four retail banks accounting for 86% of bank lending[38]. There are also a number of smaller local, regional and international players.

Net interest income accounts for around 76% of banking sector operating income, while fees and commissions account for around 16%[39]. Residential mortgages account for around 57% of bank lending[40]. Agriculture accounts for around 14% of bank lending[41]. Non-bank lenders compete with banks in some regions and products, but are small compared to the banking sector[42].

Profitability of New Zealand banks remains strong, and the RBNZ considers the financial system as a whole to be resilient – although potential risks related to a slowing or falling housing market, agricultural indebtedness and reliance on offshore funding are present.

The sector is facing potentially significant regulatory change, including the possibility of an increase to the minimum capital requirement for banks[43]. Other regulatory and legislative reform includes the review of the Reserve Bank of New Zealand Act 1989 and, most significantly from a conduct perspective, the Government commitment to fast-track legislation to enhance conduct regulation for banks and insurers.

Technology developments have the potential to bring significant change to the banking sector, driving new product and service offerings as well as undermining banks' traditional role as intermediaries.

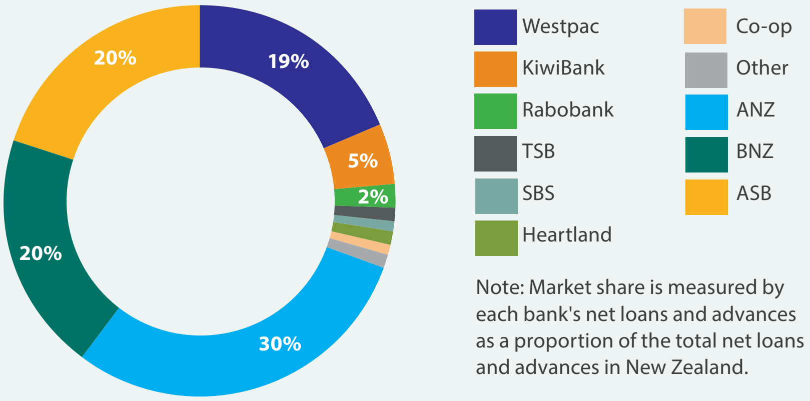
Payments NZ has recently launched an application programming interface (API) centre to promote enhanced openness in payments and banking[44]. APIs facilitate 'open banking' through the establishment of common standards to enable efficient and safe customer data sharing.

Other technologies such as artificial intelligence (AI) and distributed ledger technology are also being explored. However, most initiatives in New Zealand are small in scale or only at the proof-of-concept stage.

As with all innovation, such developments have the potential to provide significant benefits for customers, but may also give rise to new risks.

Bank market share

Source: RBNZ, as at 31 March 2019



Note: Market share is measured by each bank's net loans and advances as a proportion of the total net loans and advances in New Zealand.

NZ bank profitability (before tax, $m)

RBNZ Bank Dashboard Quarter ending 31 March 2019

Cyber-risk and data protection issues are of ongoing importance to banks, given their reliance on personal data and technology. Cyber-resilience issues may be amplified by underinvestment in IT infrastructure, the patchwork nature of many systems and the prevalence of dated systems and hardware.

Our recent work on cyber-resilience highlighted that large banks reported high levels of cyber-resilience, in keeping with their view of the level of cyber-risk applicable to them[45]. Cyber-attacks on bank customers are also an area of concern[46].

Insurance

Compared to other countries, New Zealand has good levels of general insurance penetration, while life insurance penetration is relatively low. The insurance sector is concentrated with a few large insurers, especially for some products like health insurance[47].

As at March 2019, insurers earned a gross premium of $10.1 billion and had gross claims of $5.8 billion[48].

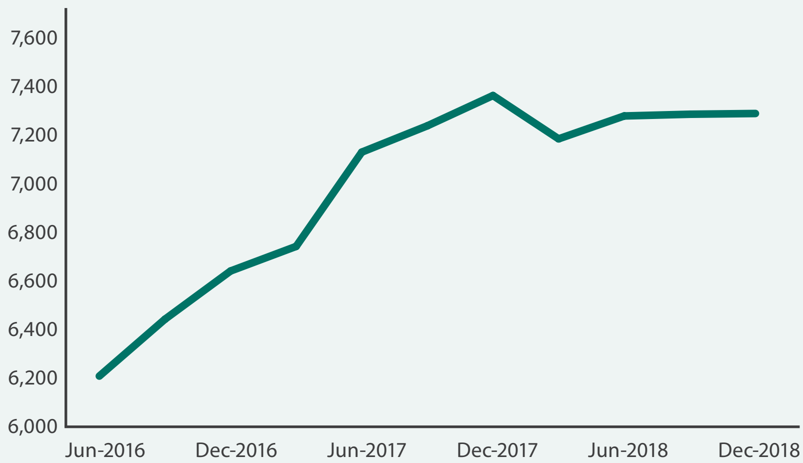
Although New Zealand currently has good access to general insurance products, this could change as insurers (as well as banks) increasingly factor climate change and geological risks into decision-making.

Technology developments such as the use of big data and AI are also beginning to affect the pricing of insurance risk. While offering the potential to provide more accurate risk-based pricing, there is concern they will make it harder for some customers to access or afford insurance.

Distribution of insurance in New Zealand tends to be highly intermediated, particularly for life insurance. The level of commission payments made to intermediaries/agents for New Zealand life insurance contracts is very high when compared globally, although this varies across different products.

Net earned premium ($m) - insurance

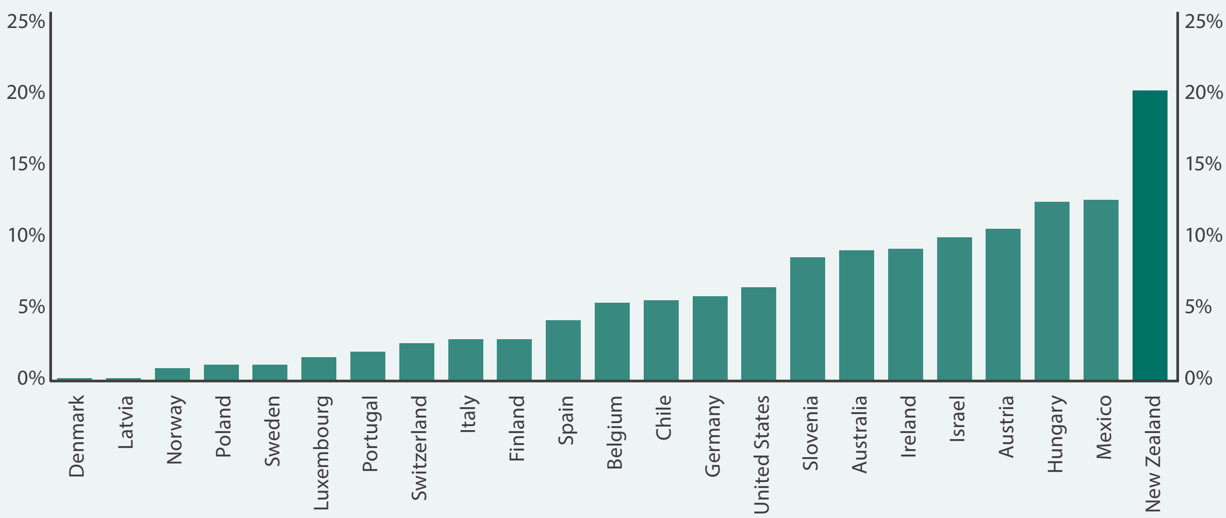
Source: RBNZ J10



Comparison of life insurance commissions worldwide

Life insurance commissions (% of gross premium revenue)

Source: OECD, RBNZ Quarterly Insurer Survey. Note: Data is for 2016.



Assessment

Our assessment of these sectors was largely limited to the Conduct and Culture reviews of retail banks and life insurers. While the reviews did not find widespread misconduct, we did find a lack of effort and processes to identify and monitor conduct risks. The reviews also highlighted existing regulatory gaps. Our thematic review of bank incentive structures noted concerns with highly sales-focused remuneration structures, although we welcome recent commitments from banks to remove all sales incentives for frontline staff and managers. Similarly, our previous thematic reviews found concerns with incentives and commissions in the insurance industry. Our assessment demonstrated the need to continue working with this sector to embed good conduct-risk management in firms.

Sector risks and harms we want to address

Governance and culture – the governance and culture of banks and insurers does not give sufficient weight to serving customer needs and managing conduct risks.

Incentives and conflicted conduct – incentives drive sales outcomes to the detriment of customer outcomes, and conflicts are poorly managed.

Systems and controls – inadequate systems, controls and processes for identifying, managing and reporting misconduct.

Product suitability – insufficient consideration of customer needs in the design and ongoing performance of products.

Remediation of conduct issues – remediation is too slow or insufficient, and lacks senior management focus.

Technology and business transformation risks – IT system constraints, underinvestment, reliance on manual processes, poor implementation and consistency in system use, and the rise of cyber-threats.

Remit risks – absence of conduct powers and therefore FMA regulatory oversight in relation to banking and insurance.

Long-term opportunities and challenges

Our assessment also identified a number of long-term opportunities and challenges that may increase or decrease risk.

Policy and regulatory reform, including the Government's response to the Conduct and Culture reviews, and any potential remit change for the FMA. This may drive changes in market structure, and impact horizontal and vertical integration, and disintermediation.

Treatment of vulnerable customers by banks and insurers.

Appendix: Overview of sector view framework

Our sector approach

Our sector view framework allows us to build an understanding of how a sector operates and how it is changing, and to identify areas of current and potential concern. The framework provides the basis for the SRO and is therefore a critical input into our business planning for the coming years.

More specifically, sector views enable us to:

- identify and monitor risks in each sector, enable prioritisation and comparison across sectors, and target our activity accordingly
- provide a framework for monitoring how sectors are changing, by tracking key trends and developments
- undertake cross-sector conduct assessment based on what a well-functioning sector might look like, identifying knowledge gaps and areas of future focus
- build a shared understanding of how sectors operate and are interlinked, and how well they are working
- provide a framework for strategic decision-making and business planning.

The sector views seek to provide a point-in-time assessment of how well New Zealand's financial sectors are working, based on available information. They also bring together research and insights to identify trends and developments that reflect potential drivers that may increase or decrease risk. This includes looking at international regulatory developments.

Defining/understanding the sector

The first step is to determine and define the sectors. We do this by considering the needs a sector fulfils. This involves analysing the:

- key products and services offered within the sector
- market structure and business models
- size and scale (including value chains)

We then map out the key components that comprise the sector – we call these sub-sectors. Each sub-sector provides a significant function that underpins the overall functioning of a sector. We deliberately include elements of sectors that we do not directly regulate, as understanding these is often critical to understanding how effectively sectors are operating, and where risks and harms may arise. That said, the focus of our assessment generally tends to be on elements that fall directly within our remit.

Identifying trends and developments in the sector

Once we understand the sector, we seek to determine how the sector is changing and what is driving that change. To achieve this, we undertake an environmental scan that involves tracking:

- macro-economic drivers
- domestic and international policy and regulatory developments
- technology, innovation and product developments
- developments in market structure and/or firm behaviour
- changes in consumer and investor behaviour.

Assessing the sector – identifying risks, harms and emerging issues

We then assess the sectors and sub-sectors using a standard framework built on what we consider to be the attributes of a well-functioning market. The framework is tailored to specific sectors/sub-sectors and includes assessment across the following areas.

Sector assessment framework

Efficiency and market structure	Concentration of the sector, barriers to entry, and market structure
Access	Barriers or challenges for customers or market participants to access products or services
Stability and resilience	Stability of the sector and participants
Conflicts of interest	Prevalence of conflicts and how well they are managed
Governance and culture	Corporate governance and management of conduct risks
Systems and controls	Adequacy and sophistication of systems and controls
Disclosure and transparency	Information asymmetries and poor disclosure
Integrity	Fraud, market manipulation, insider trading, money laundering and other practices
Regulatory issues	FMA mandate, approach and regulatory gaps
Customer capability and engagement	Understanding of products and services, treatment of customers, and presence of vulnerable customers

In assessing the areas of the framework, we are not only asking how well these elements function in the sector but also what risks and harms may be present. This allows us to identify and prioritise significant harms and risks.

As part of the sector assessment, we also determine our current level of knowledge within each sub-sector and areas where we would like to gain additional data and intelligence.

Based on our sector and sub-sector assessments, we identify key sector risks, in addition to longer-term opportunities and challenges to promoting fair, efficient and transparent markets. We will continue to monitor these trends and respond where necessary.

Once we complete the assessment for all the relevant sectors, we form a view of which risks cut across all the sectors, which helps inform our priority setting.

Strategic priorities

Taking into account the risks, opportunities and challenges identified through the sector view process, we determine our strategic priorities. The priorities outline the areas that we will focus on in the coming years.

Notes

1: For more information, CoFR members have agreed to a regulatory charter to set expectations of how the regulatory system operates.

2: Environmental, Social and Governance

3: Stranded assets are assets that have suffered from unanticipated or premature write-downs, devaluations or conversion to liabilities.

4: Wrap platforms provide facilities for investments to be traded, held and reported on.

5: Financial Stability Report May 2019, RBNZ

6: In this context, tail risks are low-probability, high-impact risks.

7: Brief for Incoming Minister – Seniors 2017, Ministry of Social Development, pg 8

8: Ethnic diversity projected to rise, Stats NZ

9: Low-emissions economy – Final report 2018, New Zealand Productivity Commission

10: Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry

11: Market Operator Obligations Review – NZX

12: NZX Annual Report 2018 and Market Operator Obligations Review – NZX

13: Market Operator Obligations Review – NZX

14: NZX and FMA initiate industry review: Capital Markets 2029

15: Eight new Smartshares ETFs debut on the NZX today

16: Startup Investment New Zealand 2019, PwC

17: Peer-to-peer and crowdfunding: sector snapshot, FMA

18: USX Newsletter, June 2019

19: Market Operator Obligations Review – NZX

20: Algorithmic trading 2018 thematic review, NZX

21: NZX Annual 2018 Operational & Regulation Metrics

22: NZX – all market participants

23: Going broke in stocks, The Economist

24: The big flaw: auditing in crisis, Financial Times

25: Audit Quality Perceptions Research 2019, FMA

26: Funds under management ($m), T40, RBNZ

27: KiwiSaver ($m), T43, RBNZ

28: KiwiSaver Annual Report 2018, pg 5

29: FMA internal analysis based on 2018 annual returns

30: KiwiSaver Annual Report 2018, pg 16

31: KiwiSaver Annual Report 2018, pg 4

32: KiwiSaver Annual Report 2018, pg 10

33: The implications of passive investing for securities markets, 2018, BIS Quarterly Review

34: FCA Asset Management Market Study – Final Report, FCA, pg 4

35: IMF NZ FSAP Assessment 2017

36: FCA proposes permanent measures for retail CFDs and binary options, 2018

37: Netsafe Quarterly Report October – December 2018

38: Financial Stability Report May 2019, RBNZ, p20

39: Banks: Income statement ($m) – S21, March 2019, RBNZ

40: Banks: Assets – Loans by purpose, May 2019, RBNZ

41: Banks: Assets – Loans by purpose, May 2019, RBNZ

42: Financial Stability Report May 2019, RBNZ, pg 20

43: Review of the capital adequacy framework for registered banks, RBNZ

44: Payments NZ launches API Centre

45: Cyber-resilience in FMA-regulated financial services, 2019

46: Malware targeting business customers of New Zealand banks, CERT NZ

47: Financial Stability Report May 2019, RBNZ, pg 20

48: Insurance: Income Statement – J10, RBNZ

Auckland

Level 5, Ernst & Young Building
2 Takutai Square, Britomart
PO Box 106 672, Auckland 1143

Phone: +64 9 300 0400

Wellington

Level 2, 1 Grey Street
PO Box 1179, Wellington 6140

Phone: +64 4 472 9830

fma.govt.nz

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TE MANA TATAI HOKOHOKO - NEW ZEALAND