Strategic risk outlook 2017

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

Contents

Risk outlook

Understanding our approach

Our purpose
Page 22

Our role as a New Zealand regulator and how we achieve our wider goals.

Our environment
Pages 23–27

Who we regulate and the specific factors that influence our approach to financial regulation.

How we identify and respond to risk
Pages 28–29

Our approach to risk management and when we intervene to prevent harm in our financial markets.

Key points

What is the SRO?

The SRO outlines the root causes of risk to fair, efficient and transparent financial markets. It sets out the potential risks connected to these drivers and to our related strategic priorities. The SRO has a local focus, but a global perspective. So while our job as a regulator is to address risks in New Zealand's financial markets, we also pay attention to and learn from the risks identified in overseas markets; and how other regulators respond to them.

How to use the SRO

We hope this document explains how we work and the results we want to see – specifically in our direct engagement with stakeholders and those we regulate.

Why are we refreshing the SRO?

We are moving from FMC Act implementation to operating as a conduct-based regulator with our newly licensed populations. Our increased funding from July 2017 enables us to plan further ahead. Updating our SRO is the first step in our 2017-18 planning cycle.

What's different about this SRO?

Our drivers of risk have been updated and, for the first time, we set out the underlying strategic risks that could affect our regulatory outcomes. Overall the seven strategic priorities we identified in the SRO 2015 remain valid and stable. In this SRO, we set out a wider range of demographic factors that will influence our work.

We also offer further insight into the factors that support our decision-making, and the influences we consider when we identify the extent of risk or harm to our financial markets; which are the most important, and what we can do about them.

Other areas on our risk radar

We identify some developing themes to keep on our risk radar. We want to engage with key stakeholders to understand their views and to aid our analysis of these areas.

These themes are:

- Regulating for rapid technological innovation
- Reviewing our regulatory perimeter
- Retail investor participation of complex and risky products
- Helping investor decision-making in changing market conditions.

Increased transparency

Our key strategic documents, like the SRO, explain how we identify and prioritise risks, the actions we take to achieve our objectives, and the resource allocated to those actions. The diagram on page 4 shows how these documents fit together.

This increased transparency takes on board feedback from government and industry who asked for more clarity around the regulatory outcomes we seek and the activities needed to achieve them.

Future planning

Our Annual Corporate Plan, published later in 2017, will build on the SRO. It will outline the activities under each strategic priority that we believe can most effectively minimise conduct risks and improve behaviour within New Zealand's markets.

Let us know what you think

If you would like to share your views on our SRO or if you have any questions, please get in touch with us.

You can send feedback to: questions@fma.govt.nz

Risk outlook

Setting the scene

First we look at the root causes of risks to our financial markets and determine which are at play, and to what extent. In particular, we look for combinations of root causes, or risk drivers, that materially threaten the fairness, efficiency and transparency of New Zealand's financial markets – these become our strategic risks outlined on page 6.

Then we consider which strategic risks we are best placed to respond to, either separately or with others, and define the outcomes we want to see from our intervention. This combination of strategic risk identification, assessment of harm and the appropriate regulatory outcome, together informs our strategic priorities.

Once these priorities are established, we decide how they translate into specific areas of focus. These decisions flow into our business-planning process, with the activities for each financial year set out in our Annual Corporate Plan.

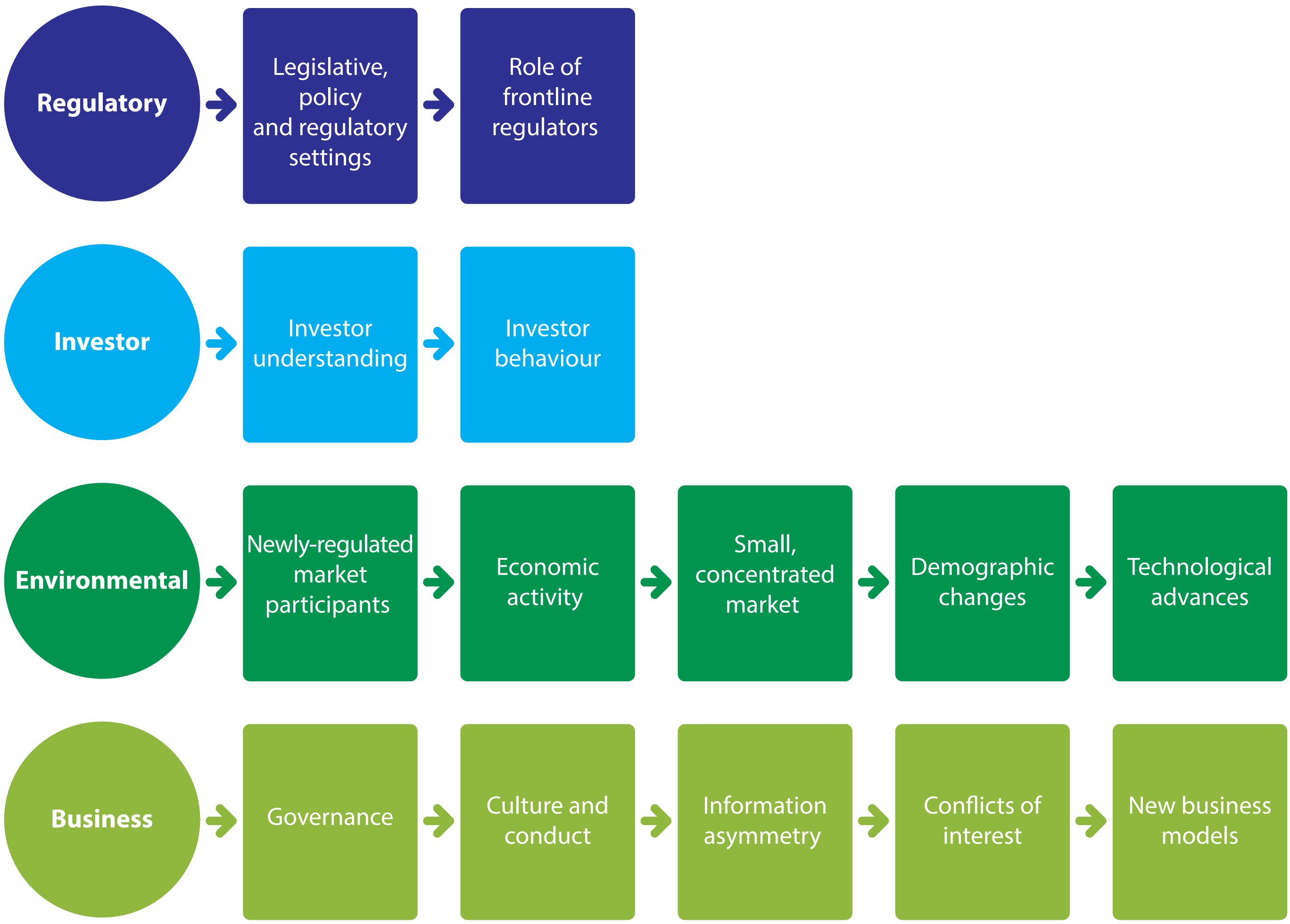
Here we set out our full planning cycle and which documents relate to each part of the process.

Drivers of risk

Below are the main drivers of risk we see to our objective of fair, efficient and transparent financial markets.

We encourage those we regulate to consider how these drivers could impact their business, product design and delivery.

See pages 15-20 for more detail on each risk driver.



Strategic risks

These risks are the current high-impact threats we see to fair, efficient and transparent financial markets. Identifying risk is an on-going process, and these risks are regularly reviewed.

Governance

Ineffective governance leads to poor conduct in organisations and has a negative impact on investors.

Mis-selling of financial products

Consumers are sold products that do not meet their needs.

Disclosure to Investors

Inadequate disclosures make it difficult for investors to understand the risk-return trade-off.

Investor capability and access to information and advice

Investors do not have access to good quality information or advice to make informed and effective investment decisions.

Market infrastructure

A failure in provider infrastructure impacts market integrity and confidence.

Cyber resilience

Inadequate cyber resilience of financial service providers causes a loss of investor confidence in our markets.

Frontline regulators

Ineffective frontline regulation adversely affects our financial markets.

Wholesale market conduct

Poor conduct in wholesale markets impacts overall market confidence.

Trading misconduct

Insider trading, market manipulation and other unethical trading activities erode investor confidence in markets.

FMA effectiveness and efficiency

Failing to operate as an effective intelligence-led and risk-based regulator impacts our ability to achieve our objectives.

Regulatory perimeter

Activities outside the scope of our regulatory powers adversely affect market integrity.

Setting the strategy

Here we detail our key priorities, informed by the risks we've identified, followed by the regulatory outcomes we want to see.

Investor decision-making

We want to see:

Capable, confident and well-informed investors.

Governance and culture

We want to see:

Boards and senior management leading organisational culture and placing customer interests at the centre of their business strategies.

Conflicted conduct

We want to see:

Conflict-management procedures designed to put customer interests first.

Capital market growth and integrity

We want to see:

Resilient and dynamic capital markets with broad investor participation and sound infrastructure.

Sales and advice

We want to see:

Sales and advice practices designed to meet the needs of customers.

Frontline regulators

We want to see:

Frontline regulators who contribute to well-regulated financial markets.

FMA effectiveness and efficiency

We want to see:

The FMA as an efficient and effective intelligence-led regulator.

Developing themes

By keeping the themes below on our risk radar, we want to better understand their impact on us, the wider financial sector and those who work with us.

- **Regulating for rapid technological innovation**
- **Reviewing our perimeter**
- **Retail investor uptake of complex and risky products**
- **Helping investor decision-making in changing market conditions.**

We expand on these themes below. These are not new issues, and we are aware of the risks and opportunities they present. However, where new risks or impacts stem from these developing themes, we need to explore these. We want to openly engage with those we regulate about these issues. We welcome debate around further risks to our objectives, and we want to know how important you think they are.

Regulating for rapid technological innovation

As set out in the Drivers of risk section on page 18, new technologies bring significant benefits to investors and businesses. Technology brings greater efficiency of transactions, lower business costs, improved product comparison and offers access to a wider range of services.

However, there are risks associated with an increased reliance on technology-driven products and services. These include: increased exposure to complex products for retail investors, data security vulnerabilities, and a time lag between their release and effective regulation to manage risk.

On balance, we believe the benefits are worth pursuing, provided the risks are managed well.

We support and encourage technological innovation in financial services, and our regulatory settings are flexible enough to embrace innovation.

For example, we acted quickly to implement licensing of peer-to-peer lending and equity crowd-funding platforms as well as other simplified funding channels for companies. We encourage companies who are active in this space, or in other innovative areas, to talk to us about their plans at an early stage.

Over the next five years innovation will reshape how financial services are consumed, accessed and structured.[1] Other regulators are already considering what this rapid pace of technological change means for the risk profile of the industries they oversee. Balancing the reduction of risk with innovation and improved efficiency in the sector is the challenge that we and other international regulators currently face.

1 World Economic Forum, The Future of Financial Services, June 2015

Working in collaboration with other regulators and industry partners, we want to better understand how these changes and innovations will shape the future of financial services regulation in this country, and reach a common understanding of the risks and opportunities.

Reviewing our perimeter

We do not regulate the conduct of all financial services, providers and products. The activities that we do not regulate, but that represent risks to us, due to the potential harm to investors, we call 'perimeter' issues. For example, the core product areas of banks and insurers, FX trading, and certain services offered by overseas entities, are outside our scope of control. We also do not license all financial advisers – although there may be some change in the near future in this area.[2]

In these cases, consumers do not always have effective recourse to dispute resolution schemes or legal remedies, and we cannot always prevent misconduct.

Where sales practices are covered by the Fair Dealing provisions of the FMC Act, we can make use of our fair dealing powers under the Act, but not all types of product and conduct are covered by the provisions.

We also have limited powers to protect consumers and investors from fraudulent schemes or scams that originate beyond our regulatory reach or from outside New Zealand, apart from issuing warnings on our website.

We are concerned that businesses or individuals with little or no business connection to New Zealand seek inclusion on the Financial Services Providers Register (FSPR), which is maintained by the Companies Office. Registration may be valuable to these offshore companies, as it gives them perceived legitimacy, as if they were regulated in New Zealand, to carry out business activities.

We want to prevent offshore businesses from using, or damaging, New Zealand's good financial reputation and effective regulation.

We will continue our work with the Companies Office, Department of Internal Affairs and MBIE. Where necessary, we will take enforcement action, to prevent harm to investors and to the integrity of New Zealand's financial markets.

We regularly review the perimeter of our regulation, in line with the International Organization of Securities Commission's (IOSCO) principles for financial regulators. We are keen to initiate debate about the extent to which our regulatory powers should address market conduct beyond the FMC Act Fair Dealing provisions. The International Monetary Fund Financial Sector Assessment Programme (FSAP) review findings, published later in 2017, may also include recommendations on this topic.

2 See Review of Financial Advisers Act 2008 on MBIE website: www.mbie.govt.nz/info-services/business/business-law/financial-advisers/review-of-financial-advisers-act-2008

Retail investor uptake of complex and risky products

While complex financial products have always been available, lower interest rates and volatile equity markets typically lead to more of such products emerging to meet investor desire for higher returns.

We see possible harm to consumers, as complex products and the risk-return dynamics involved are more difficult to understand. The more complex a product is, the harder it becomes to create clear and concise disclosure documents that enable investors to make informed decisions. Risks of mis-selling increase, and investors may not understand the key product features or the risks to their investment goals. For example banks' increased use of sub-ordinated unsecured debt instruments to meet their regulatory capital requirements has led to concerns in several jurisdictions over whether these instruments are suitable for retail customers.

More broadly, if investors are classified (or classify themselves) as 'wholesale investors' in order to gain access to certain products but lack requisite knowledge, this also brings increased risk, as wholesale investors do not have the same protections, such as disclosure, as retail investors.

Similarly, retail investors may not fully understand the inherent risks in non-mainstream property-related offers (syndicated or other indirect investment structures) in New Zealand.

We have also noticed an increase in foreign exchange and binary option trading providers who target New Zealand investors to trade through their platforms.

While the products are not necessarily complex, they often use leverage, with the suggested higher returns never materialising, and investors not fully understanding the risks of loss.

In some cases, the businesses are just operating investment scams – see our website for more information about what to watch out for with investment scams.

A recent IOSCO survey[3] on similar over-the-counter leveraged products reveals that research done in several markets shows that the large majority of investors in these types of products often lose money and the products bring investor complaints. Common concerns in other countries include product marketing, the quality of disclosures, high leverage and operational issues, such as fair pricing and order execution, as well as conflicts of interest management.

We will continue to monitor these types of products and how they are sold to better understand what future action we would take.

3 Report on the IOSCO Survey on Retail OTC Leveraged Products, FR14/2016, December 2016

Helping investor decision-making in changing market conditions

Although we have been experiencing low interest rates for some time now, and investment returns in some asset classes have been strong, the time will come, inevitably, when interest rates will rise again. The extent and pace of this change may challenge many investors' investment plans.

One example is conservative and balanced KiwiSaver funds which often include a high proportion of long-term bonds that carry some risk. Bond issuers may not repay the money, especially in an environment of rising interest rates. What's more when interest rates rise, the bonds decrease in value, providing negative returns over the short term.

Default funds, specifically, tend to have a higher proportion of investments in long-term bonds so, when interest rates rise and bond values fall, there is a risk that those funds will experience negative returns. This could lower the overall confidence in KiwiSaver and drives ill-considered switching. It is important that we continue working with default KiwiSaver fund providers[4] to improve the financial capability of their customers, and ensure investors have confidence in their long-term KiwiSaver investments.

4 KiwiSaver annual return data (as at 31 March 2016) 400,000 people are in KiwiSaver default conservative funds equating to $4.2 billion of funds under management (12% of total KiwiSaver investments).

Learning from our work

We strive to be a learning organisation. This section offers insight into our work over the past few years, and how it has informed our current approach to the assessment and identification of risks.

Governance and culture

We created a guide outlining our view of conduct. It explains to the industry and investors how we will use conduct as a 'lens' to look at how providers behave when meeting their existing obligations to customers. It will also shape how we interact with businesses and individuals when we see poor conduct. See more on how we apply our conduct lens on page 30.

Sales and advice

Since 2015, we have gained a better understanding of what information and advice KiwiSaver investors need to help them make good decisions, and the barriers which exist to them getting that help. What we've learned is informing our approach to all managed investment schemes.

Investor understanding

Through market engagement, we have learnt more about the needs and preferences of those nearing retirement. We will build on this with other agencies to help improve access to advice at the point of retirement.

We have applied behavioural insights to the design of regulation and started to work with providers to trial initiatives that encourage consumers to make better financial decisions.

We will continue to work with issuers to improve the quality of disclosure documents. The transition to the new FMC Act regulatory regime has been a learning experience for us. This process required us to engage closely with issuers and their advisers about disclosure documents before registration. Over time, we will, move towards more risk-based and thematic monitoring of disclosure documents to ensure they are clear and understandable. This will help create disclosure that is of real value to investors.

Conflicted conduct

Our review into life insurance sales practices has given us a benchmark to guide similar reviews into sales practices and the impact of incentive structures in the future.

Capital market growth and integrity

We will draw on our experience of regulating new and innovative funding channels such as peer-to-peer and crowdfunding lending to continue to support growth and innovation in our capital markets.

We have worked to improve our relationships with market participants and their advisers. We now want to extend this approach to investment banks.

We have begun to look at wholesale activity and its impact on retail investors. For example, we have started looking at engaging with NZX, banks and other trading businesses to clarify the boundaries of acceptable wholesale trading practices and behaviour.

Effective frontline regulators

Our increased engagement with frontline regulators has been rewarding. We have seen better quality and more timely secondary market referrals from NZX. We will continue our work to raise the effectiveness of all frontline regulators.

FMA efficiency and effectiveness

We commissioned an external 'efficiency and effectiveness' review, published in 2016. The review identified areas where we could improve our operations. Our additional funding will allow us to implement these recommendations into our working practices.

We have also started to build our data analytics capability, and increased our use of data visualisation tools to evaluate previously unconnected datasets. Some examples of this include the work in our annual KiwiSaver Report and our review of the insurance industry in 2016.

We also use analytics to consider data on FSPR-registered entities alongside complaints data and Companies Office Register information. This way we can analyse the connections of registered entities that we have concerns about, and can improve our ability to identify and reduce risks.

International risk snapshot

We keep a watchful eye on what other regulators and international organisations are doing in the risk space. It helps with our own assessment of the key risks and their effect on our strategic priorities.

Common regulatory themes include: conflicts management, culture, sales and advice, cyber security and structural change.

International regulators risk viewpoint

IOSCO Risk Outlook 2016

Corporate bond market
Use of collateral
Harmful conduct
Cyber threats

SFC Annual Report 2015-6

Corporate governance
Conflict management
Safe custody and liquidity management
Intermediaries

AMF Risk Outlook 2016

Macro-eco environment
Bond market liquidity
Digital disruption
Cyber security

FINRA Priorities Letter 2016

Conflicts of interest
Sales practice
Market integrity
Technology
Liquidity management
Outsourcing

AFM Agenda 2016-18

Investor capability
Conflicted conduct
Cyber attacks
Arrival of new players
Auditors' working practices

ASIC 2016 Corporate Strategy

Cyber security/digital disruption
Culture and conduct of financial services gatekeepers
Cross-border businesses
Design/distribution of retail products and lack of consumer understanding

FCA Business Plan 2016

Pensions
Financial crime and anti-money laundering
Wholesale financial markets
Innovation and technology
Firms' culture and governance
Advice
Treatment of existing customers

International industry risk viewpoint

FMA Institutional Investor Survey 2016

Search for yield
Leverage
Capital flows
Cyber security
Housing market

Allianz Risk Barometer 2016

Business and supply-chain disruption
Market developments (volatility, intensified competition and market stagnation)
Cyber security

PWC Banana Skin Survey 2015

Rising debt levels
Cyber security
Conduct practices in risk management in banks

Emerging Risk Survey 2015 Society of Actuaries

Cyber security
Financial volatility
Terrorism
Regional instability

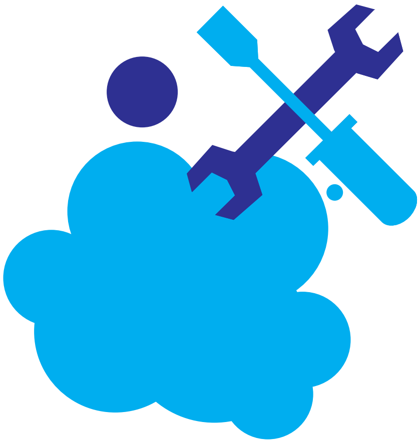
World Economic Forum 2016

Asset bubbles
Cyber security

NZ Investment & Operations Outlook 2016 (BNP Paribas)

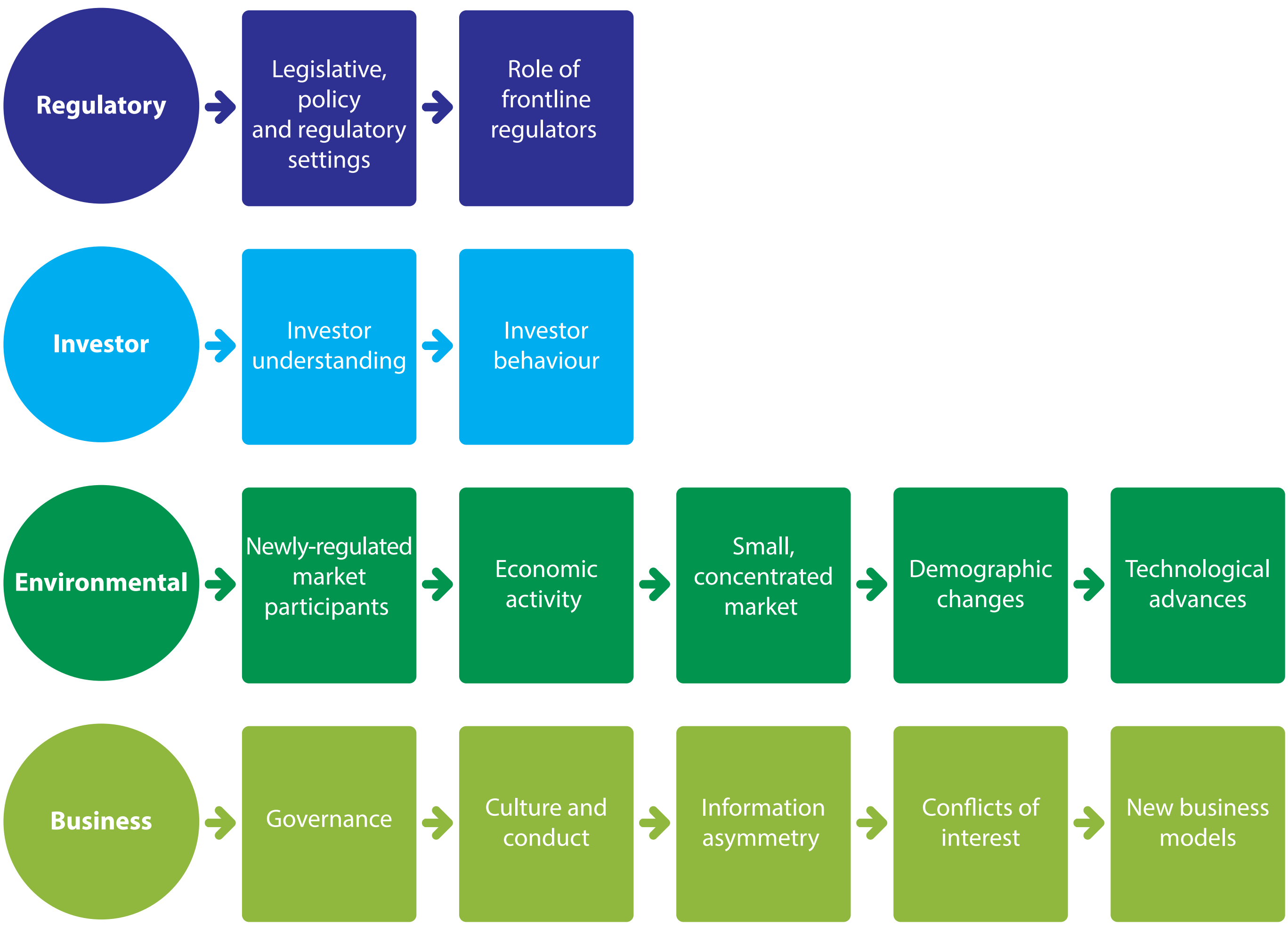
Search for yield
Rising regulatory reporting requirements
Rise of digital disruption

Drivers of risk



Risk drivers are the root causes of risk. We regularly review the financial markets' landscape both overseas and at home. We have updated these risk drivers to incorporate any key developments we've seen since the first SRO was published in December 2014.

Most drivers of risk are common to all financial markets, however some causes are specific to New Zealand's markets. As the diagram below shows, we group the drivers according to their 'source'. This helps us to assess our response to a particular risk or risks. For example, to lessen a risk caused by the drivers of 'investor understanding' and 'investor behaviour', an intervention directed at investors would be beneficial. However, risks with multiple causes will need more than one intervention to affect change. We encourage those we regulate to think about how these drivers may impact their conduct and business activities, and most importantly, the effect they have on their customers or investors.



Regulatory

Legislative, policy and regulatory settings

As a risk-based regulator, we aim to balance the need to reduce or remove harm with the promotion of innovation and market growth. Our regulatory approach needs to be flexible enough to keep pace with changes to business practices and market structure. We want to make sure our policy and legislative settings do not, unintentionally, create additional risks to our financial markets.

New Zealand's regulatory structure is also fairly complex, with a number of regulatory players. Lack of co-ordination and communication between regulators could limit our ability to achieve our broader objectives.

Role of frontline regulators

Frontline regulators, such as licensed supervisors, accredited audit bodies and the NZX, play a crucial role in New Zealand's financial markets. They have an important responsibility to oversee the conduct of different market groups including fund managers, KiwiSaver providers, listed issuers and auditors.

The overall integrity of New Zealand's financial markets depends heavily on the integrity and effectiveness of our frontline regulators. So it is essential that regulators have a thorough understanding of the businesses they oversee; robust monitoring arrangements in place; and knowledge of the relevant sector risks. To be effective, frontline regulators must also allocate sufficient resources and apply the right level of professional inquiry and scepticism to their work.

Investor

Investor understanding

Investor understanding is an essential part of healthy financial markets. Our 2015 survey focusing on the 'over fifties' showed New Zealanders have low levels of understanding about basic investment concepts such as risk, return and diversification.[5] Despite only one quarter of those surveyed being aware of their tolerance for risk, eighty per cent of participants would avoid high investment risk, and seventy per cent believed 'most people' should choose lower risk investments.

The changing ethnic and cultural make-up of our population also means that some investors may find it particularly difficult to understand product disclosure statements and may have a limited grasp of their legal rights. Low investor capability and gaps in investment knowledge are also significant drivers of risk.

This driver of risk reduces when investors receive clear communication about the risks of financial products.

5 FMA and CFFC survey into older New Zealanders' Planning and Expectations for Experience of Retirement

Investor behaviour

Human nature often leads people to make poor decisions about investment, especially about complex questions such as: 'How much do I save for a comfortable retirement?' or 'Which products do I choose to help get me there?'

If businesses and individuals understand how investor decision-making can affect behaviour, it will help them tailor their financial products and services to better meet investors' needs.

We understand the potential for providers to take advantage of investors' patterns of behaviour in a way that is not in the investors' interests.

Environmental

Newly-regulated market participants

Most of New Zealand's financial service providers are newly regulated. The concept of 'conduct regulation' is new to us, and to many of those we regulate.

Our role is to supervise these providers, which gives us certain legal powers and regulatory responsibilities. Some businesses and individuals who are new to regulation may be unclear of our expectations of them – especially when these expectations are new and untested. This can lead to low standards of conduct and compliance amongst providers, and put market integrity at risk.

As a conduct regulator, we aim to be open and approachable, offering guidance to those we regulate so that they clearly understand what we expect.

Economic activity

The state of the economy directly influences the types of financial services and products sold. It also affects the behaviour of businesses, individuals and investors, as well as the needs of consumers.

Low interest rates over recent years have led to the emergence of products that may bring new types of complexity and risk for consumers. Investors seeking higher returns could choose products without being aware of their complexity or risk.

Small, concentrated market

New Zealand's financial markets are small, concentrated and highly connected. While some degree of connectedness is vital to a dynamic and efficient financial system, it can also amplify existing market frictions, conflicts of interest, and information asymmetries. As a small, open market, we are also the adopter of overseas legislative regimes, which can have an impact on the conduct of our financial service providers.

Demographic changes

As in many developed economies, the demographic make-up of New Zealand is changing.

Our population is ageing and becoming more diverse.

Retirement

Internationally, a shift is occurring, transferring the risks and responsibilities of funding retirement, from governments onto individuals. This shift together with an ageing population, could drive risks to fair, efficient and transparent financial markets.

For example, evidence suggests that very few people consider how long they will live. This creates a gap between what retirees have provided for and their actual needs after retirement.

There is also a risk of the mis-selling of products because consumers do not have access to adequate advice when purchasing retirement products. It's still too early to know how serious this risk is, but learning from international experience, we will continue to pay attention to it.

Younger investors

Younger generations are growing up in a very connected and tech-savvy world. Younger consumers have high service expectations, based on their experiences with technology firms. Providers and financial advisers need to adapt their approach as younger customers may bypass traditional investment models altogether to access financial services in new ways.

Cultural diversity

Increasing cultural diversity could be an additional driver of risks around governance practices, investor understanding and the quality of advice. Changing diversity challenges our business culture and accepted business norms. Migrants may have a lack of understanding of New Zealand law, or not know how to assess information about financial products, services and investments, and any associated risks, which may be heightened by low proficiency in English.

In addition, migrants may not understand their consumer rights around investments or how to make a complaint about a provider. The development of special training programmes for staff and tailored communications for new migrant customers may help address these issues.

Technological advances

New technologies bring certain business advantages, such as providing more efficient transactions, lowering business and investment costs, and deepening market liquidity. Technology can also provide benefits to investors and consumers by improving their ability to compare financial products and improving access to products and services.

However, increasing reliance on technology-driven products and solutions brings its own set of risks. Technology-based distribution methods, such as platforms, increase exposure to complex products, and investors often do not understand the associated risks.

Increased reliance on technology can heighten exposure to cyber attacks, such as theft, fraud, viruses and scams. Financial services is one of the most vulnerable sectors for cyber attacks and many New Zealand businesses do not have a cyber security response plan.[6]

Business

Governance

Directors should set and model high standards of ethical behaviour. They should hold management accountable for exhibiting this behaviour throughout the organisation. Risks to good governance occur when boards and senior management apply a 'set and forget' approach. In general, institutional investors are confident about the standard of New Zealand's corporate governance.[7] However, we want to continue to encourage financial services firms, particularly newly licensed ones, to lead from the top in terms of customer-focused outcomes and effective governance. We still see room for boards and management to strengthen their practices in this area.

Culture and conduct

Financial services firms need to demonstrate a strong culture. This translates into business conduct that focuses on putting customers first – with obvious benefits for both businesses and customers alike.

Any incentive arrangements need to align with the culture and strategy of the organisation and the customer expectation of being treated fairly.

We continue to see poor company culture and employee incentives that drive a range of risks, such as financial product mis-selling and unclear product design that result in poor investor outcomes.

Recent international scandals surrounding governance suggest that we need to play an active role in promoting the right culture and behaviours in the businesses we oversee.[8]

Information asymmetry

Information asymmetry is where there is uneven access to, and ability to understand, important information. This is a common problem in financial markets, where an investor or consumer of a financial product, has a less in-depth knowledge than the provider of the product. The risk is that investors cannot fully understand or compare financial products – which may affect their ability to make informed decisions.

Information asymmetry can be heightened when a product is complex. It can also occur in wholesale markets where participants along the distribution chain have differing levels of information and use it to their advantage. We want to see clear and concise product disclosure information to help investors assess associated risks and potential return of financial products and services.

6 PWC, Global State of Information Security Survey 2016
7 FMA Survey of Institutional Investors 2016
8 For example, www.wsj.com/articles/how-wells-fargos-high-pressure-sales-culture-spiraled-out-of-control-1474053044

Conflicts of interest

Conflicts of interest, which are inherent to certain business models, can be intensified in a small market like New Zealand. When conflicts of interest are combined with asymmetries of information, investors may find it difficult to know if an individual or business is acting in their interests.

Remuneration and incentive arrangements can also reinforce conflicts of interest. This occurs when sales staff are incentivised with bonuses solely based on sales volumes without considering the overall customer experience.

Conflicts of interest are not limited to retail markets. In fact, we believe that the conduct in wholesale markets can set the tone for wider sector conduct. Where conflicts of interest are poorly managed in wholesale markets, or counterparts do not act with integrity, overall market integrity can be undermined, which ultimately affects retail consumer confidence in the financial markets.

New business models

Innovation supports capital market growth. New technologies and the globalisation of financial services are creating new business models and increasing the interconnectivity between different market segments, as well as between different countries.

As innovation rapidly increases, regulation and business controls may struggle to keep pace with change. This can cause gaps in consumer protections. On the other hand, overly inflexible regulation places a brake on innovation and this is something we want to avoid.

Understanding our approach

This part of the SRO puts into context who we are, and who we do and do not regulate. It also explains our intelligence-led approach to identifying and responding to the risks outlined in part one.

We also offer a summary of the external and internal factors – some specific to New Zealand – that affect our decision-making and approach to financial regulation.

In this section:

Our purpose

We are an independent Crown agency and one of the two main regulators of New Zealand's financial markets – the other being the Reserve Bank of New Zealand. Our purpose is to promote and facilitate the development of fair, efficient and transparent financial markets.[9] We have additional aims that we want to achieve:

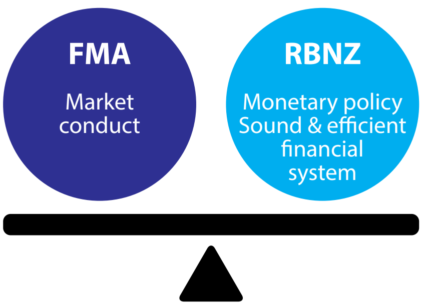
- **Strengthen public confidence in financial markets**
- **Promote innovation**
- **Support growth of NZ's capital base**
- **Balance costs and benefits.**

These aims guide our regulatory decisions and contribute to the Government's wider goal of a high-performing New Zealand economy.

Conduct regulation

Market conduct regulation ensures the financial services providers and others that we regulate act with integrity and exhibit customer-focused behaviour.

The Reserve Bank is responsible for prudential regulation and monetary policy. Prudential regulation is about individual institutional soundness and making sure that we have a robust and efficient financial system. Monetary policy is about maintaining price stability.



9 We have a range of legal powers under the Financial Markets Authority Act 2011

This section explains who we regulate and the factors that influence our approach to reducing risk in New Zealand's financial markets.

Our reach

We have a wide reach but we do not regulate all of New Zealand's financial market activities.

Our role is not to eliminate market risk, prevent all wrongdoing, or compensate investors who lose money because of misconduct.

Our core focus is to regulate the conduct of more than 11,000 financial service businesses and professionals including financial advisers, KiwiSaver providers, product markets, issuers, supervisors, fund managers, and other businesses.

This graphic shows who we regulate within New Zealand's financial sector.

Licensed financial product markets
Licensed crowdfunding providers
Licensed peer-to-peer lending providers
Designated settlement systems
FMC reporting entities
Issuers
AML/CFT reporting entities

MIS
DIMS providers
Derivatives issuers
Licensed KiwiSaver providers
Licensed independent trustees
Superannuation schemes
Qualifying financial entities
Brokers and custodians
Licensed auditors and registered audit firms (including international and NZ-based firms)

Accredited audit bodies
Licensed supervisors
NZX

Authorised Financial Advisers
Registered Financial Advisers
Qualifying financial entity advisers

Monitoring the perimeter

We monitor the businesses and individuals on our perimeter to assess their activities. If they are providing financial services, we will need to regulate what they do. However, as mentioned in the Developing themes section, we have limited scope to deal with unlicensed businesses or individuals offering financial products or services to New Zealanders.

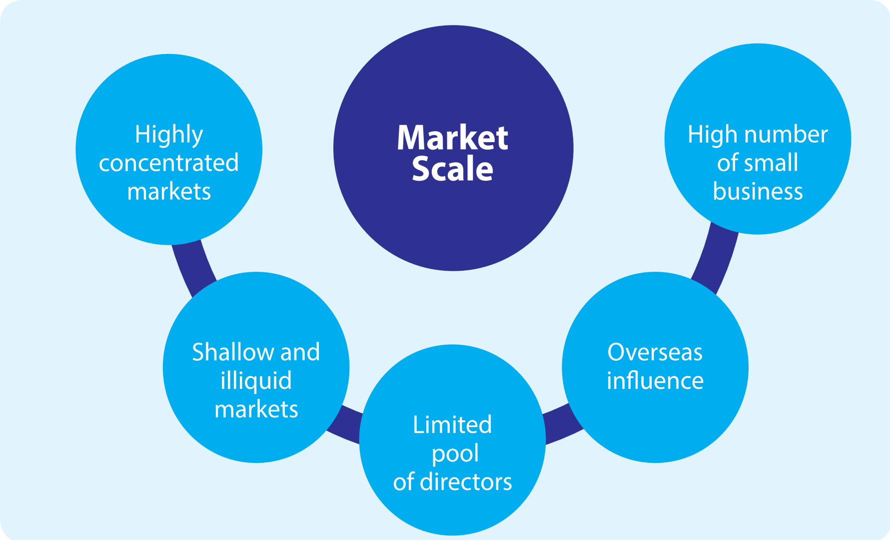
A listing on the Financial Services Provider Register (FSPR) does not mean a provider is licensed or regulated in New Zealand, or any other country. FSPR registration is not a mark of good quality or reputation, which often causes consumer confusion.

Consumers and investors can view our online lists[10] of individuals, markets and businesses licensed and authorised to operate in New Zealand.

10 www.fma.govt.nz/compliance/lists-and-registers/

New Zealand-specific features

In this section we detail the distinct features of New Zealand's financial markets.



Highly concentrated markets

Our small population creates highly concentrated financial markets. Three quarters of money invested in financial system assets is held by four major banks, and the top 10 equity stocks traded on the NZX's main board make up over half of the S&P/NZX 50 index.

Shallow and illiquid markets

Many of our markets are also relatively shallow with limited liquidity. Raising capital can be difficult for those outside of the top NZX 50.

Limited pool of directors

The relatively small number of experienced board directors in New Zealand can lead to a concentration of the most experienced directors across a small number of sizeable companies. This can lead to directors being stretched too thin in their roles. It is often difficult for small and newly established companies to attract experienced directors.

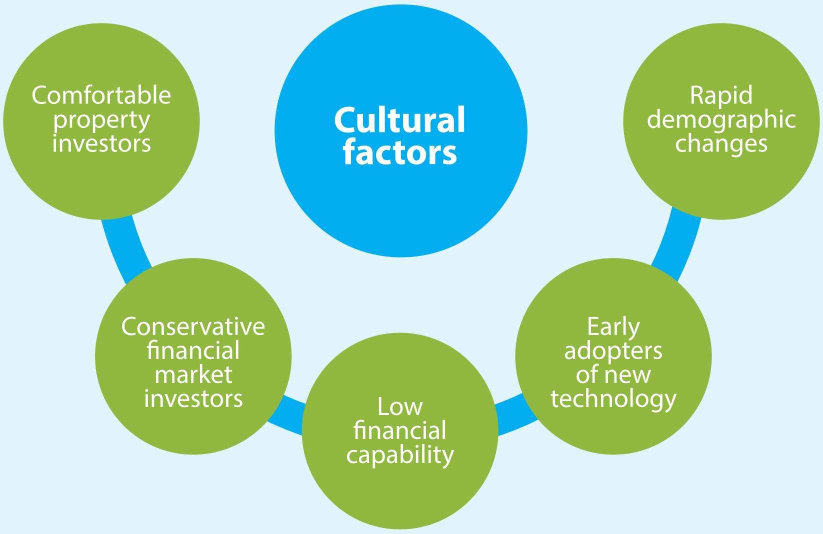
Overseas influence

Another reality of being a small economy is that the major market participants are subsidiaries of overseas businesses. This impacts on the types of risks we see and the response we take. For example, when we published information on our website outlining the risks to retail investors of investing in banks' capital notes, we took into account the Australian regulators' response, as it had considered similar issues with the Australian banks.

High number of small businesses

We are also a country of small-business owners, with a limited number of large companies.

This means the cost of regulation needs to be shared as fairly as possible across the range of participants, to ensure costs and regulatory burden do not prevent smaller players entering the market.



Comfortable property investors

Culturally, home ownership is important to New Zealanders. When it comes to owning property for personal use, or as an investment, we can be described as 'comfortable risk-takers'.

Conservative financial markets investors

When it comes to financial markets, we are more conservative investors. This can create risks when conservative investments go through periods of consistently low returns – for example, greater susceptibility to scams or a higher appetite for investments carrying higher risks, which may not be understood.

Low financial capability

Research shows that many New Zealanders have a poor understanding of basic investment concepts, such as risk versus return. The diversification and growth of KiwiSaver funds now exposes more New Zealanders to financial markets.[11]

Early adopters of new technology

New Zealanders are early adopters of new technology. This has important implications for the growth and uptake of new forms of online financial services.

Rapid demographic changes

New Zealand is currently experiencing faster cultural change than some countries. How we evolve as a nation has important implications for our approach to financial regulation, so we can both reap the benefits and manage the challenges of a more diverse population. For further reading see the Super Diversity Centre's Stocktake report 2015.

11 Standard and Poors' Global Financial Literacy Survey

Balancing costs and benefits

We aim to strike a balance between the costs and benefits of regulation. We have an extensive regulatory toolkit that allows us to tailor our response after we've assessed the level of potential harm we see to investors and the financial markets.

We deal with a cross-section of businesses, some newly regulated, ranging from small owner-operated financial advisers to large international banks and insurance companies.

We adapt our regulatory approach and the tools we use to take appropriate action where conduct does not meet our expectations or breaches our rules.

We work with MBIE, Treasury, the Reserve Bank and the NZX to consider whether policies are creating unnecessary barriers to raising capital or imposing undue cost, and whether the cumulative effect of regulation is being considered.

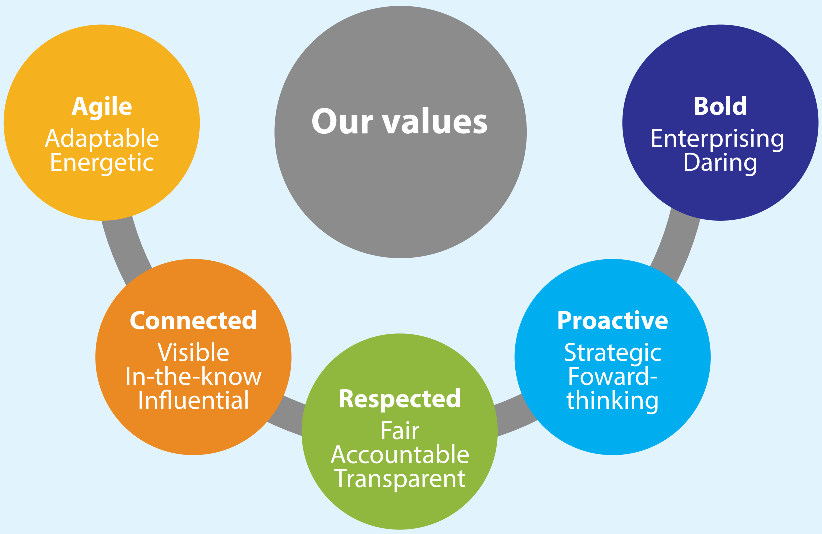
During 2015-16, we worked extensively with MBIE to tailor the Financial Markets Conduct Act to fit less standard situations. We wanted to reduce the cost of compliance for businesses as well as maintaining investor confidence and create good quality investor information.

Global regulatory standards

New Zealand is an 'importer' of global regulation. One example is the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 and its regulations, which place obligations on New Zealand's financial institutions to detect and deter money laundering and financing of terrorism. While businesses benefit from being able to show they meet international standards, it is sometimes difficult to tailor obligations specifically for New Zealand markets, and take a proportionate approach.

Our values

Our corporate values provide a strong foundation for all our work. They underpin our regulatory approach.



How we identify and respond to risk

Here we explain how we identify, assess, prioritise, and respond to the strategic risks and their root causes outlined in part one.

Intelligence led

Data and intelligence inform our decision-making. The information we collect improves our understanding of risks which helps us achieve our objectives. We use that understanding to better target our regulatory efforts using a risk-based approach. This requires investment in our people, processes and information technology. Our increased funding from July 2017 will allow us to invest further in the development of information systems and capability to improve the way we organise and analyse data and other intelligence.

Part of this intelligence-led approach entails making greater use of consumer behavioural insights to inform our supervisory focus. To find out more, read our **Behavioural Insights to improve Financial Capability** white paper. We are also partnering with businesses to put these insights and learnings into practice.

Risk based

In simple terms, a risk based approach means we focus on those sector-wide issues that will have the greatest potential to cause harm to investors, consumers, other market participants and the financial markets as a whole.

Deciding when to intervene

Before we intervene to minimise potential risks or harm, here's what we consider:

Impact

- How many customers or investors could be affected?
- What monetary value is at stake?
- We look at the total impact to all affected individuals and also the severity of the impact for those individuals. For example, how much is the potential loss to an individual in proportion to their total wealth?

Likelihood of harm

- How probable is the harm?
- Has harm already happened?

Level of financial capability

- We are more likely to intervene if the issue affects those with lower financial capability or more vulnerable groups of consumers.

Our role

- We consider if we have the mandate and then decide if intervention will make a real difference, and weigh this up against the associated costs to both ourselves and others.

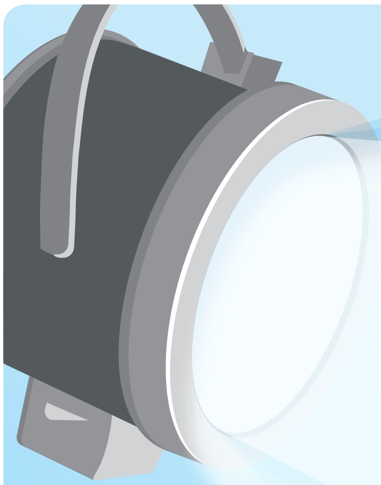
For further reading, our Regulatory Response Guidelines 2016[12] describe how we choose the most appropriate response to a breach in the financial services legislation we oversee.

Relationship management

Our risk-based approach means that from a supervisory standpoint we direct more resource towards those firms, individuals and products that we believe could cause the most harm. To support this, we have adopted a relationship management model that fosters frequent contact between us and those firms with a significant market presence or those that have the greatest potential to cause harm.

This also deepens our understanding of the firms we regulate, and offers a forum in which to raise any concerns.

12 fma.govt.nz/assets/Policies/160824-Regulatory-response-guidelines-policy.pdf



Applying a conduct lens

When we interact with regulated businesses and individuals, we apply what we call our 'conduct lens' to any issues we identify.

We have developed a guide to good conduct[13] that outlines the behaviour we expect to see from financial services providers. It covers five areas that we call the '5 Cs'. This is how we expect financial service providers to treat their customers.

Communication

- Listen to customers
- Help customers understand products and services
- Ensure good communication across whole organisation.

Capability

- Have the skills and experience to provide the right products and services
- Meet professional standards of care
- Seek continuous improvements through training.

Conflict

- Serve business and customer interests
- Disclose and discuss conflicts
- Explain related party arrangements.

Control

- Maintain systems to support good conduct
- Seek out continuous improvement
- Effectively manage complaints and disputes transparently.

Culture

- Act in the interests of customers
- Treat customers honestly and fairly
- Conduct expectations communicated clearly by leaders and understood by staff
- Address poor conduct; recognise and reward good conduct.

13 fma.govt.nz/assets/Fact-sheets/Investor-research-2015-16-June.pdf

Working collaboratively

We strive to be proactive and approachable, and to engage with the wider financial sector. This helps us to tailor our regulation to meet New Zealand's specific features, and gain insights to inform our decision-making process. It also lets us build a deeper understanding of those we regulate so that we actively keep reviewing the regulatory burden.

New Zealand Council of Financial Regulators

The New Zealand Council of Financial Regulators (COFR) has the overall responsibility and oversight of the effectiveness and stability of our financial system. Council members are: RBNZ, MBIE, Treasury, and the FMA. COFR meets quarterly to review industry trends and ensure a co-ordinated response, whenever a joint approach is needed.

We play an important part on the council. Our role is to consider the channels through which conduct in financial markets may translate into potential systemic risks. These are possible wide-reaching impacts on the sound and efficient functioning of our financial markets and economy.

For further reading, see COFR's Regulatory Charter.[14]

Wider engagement

We work closely with other agencies and departments such as the Commerce Commission, the Serious Fraud Office and the New Zealand Police to investigate and respond to misconduct or crime.

We also collaborate with the Commission for Financial Capability, MBIE, and with providers and consumer bodies such as those in our consumer advisory network, to assist with investor education and capability.

Taking a holistic approach

We work in a holistic way, rather than looking at sectors in isolation. We think this approach makes sense given the overlap between the risks we want to reduce, our relatively small size, and how our strategic priorities cut across all sectors.

Partnering with others

We also partner with universities, industry associations and research organisations to better understand market trends and emerging risks. We encourage greater knowledge sharing between government, industry and academia.

14 fma.govt.nz/assets/Uploads/council-of-financial-regulators-terms-of-reference.pdf

Glossary

AFA	Authorised Financial Advisers	A financial adviser authorised under the Financial Advisers Act 2008.
AFM	Netherlands Authority for the Financial Market	The Netherlands' financial markets regulator.
AMF	Authorité des Marchés Financiers	The French financial markets regulator.
ASIC	Australian Securities and Investment Commission	The Australian financial markets regulator.
COFR	Council of Financial Regulators	
Director		An appointed member of a Board who jointly overseas the activities and direction of an organisation and represents the interests of shareholders.
FA Act	Financial Advisers Act 2008	The Financial Advisers Act 2008 regulates financial advice and brokering services to New Zealand clients.
FCA	Financial Conduct Authority	The United Kingdom's financial market regulator.
FINRA	Financial Industry Regulatory Authority of America	The United States of America's financial markets conduct regulator.
FMA	Financial Markets Authority	New Zealand's government agency whose role is to uphold high standards of conduct within New Zealand's financial markets.
FMC Act	Financial Markets Conduct Act 2013	The Financial Markets Conduct Act 2013 aims to promote and facilitate the development of fair, efficient, and transparent financial markets and to support the confident and informed participation of businesses, investors and consumers in the financial markets.
Frontline regulator		A financial markets participant who must, by law, make sure that market participants meet their regulatory obligations and professional standards of practice.
IOSCO	International Organization of Securities Commissions	The global standard setter for securities market regulation.
Market participant		A person who is, or is required to be, registered, licensed, appointed or authorised under any financial markets legislation.
NZX	New Zealand Exchange	The information, markets and infrastructure company that operates securities, derivatives and wholesale energy markets in New Zealand.
RBNZ	Reserve Bank of New Zealand	New Zealand's central bank.
RFA	Registered Financial Adviser	Registered financial advisers can provide advice on category two investments (eg bank deposits and insurance products) that have no investment component.
SFC	Securities & Futures Commission of Hong King	Hong Kong securities market regulator.
Systemic risk		According to IOSCO, a systemic risk refers to the potential of any widespread adverse effect on the financial system and thereby on the wider economy. Factors that can give rise to systemic risk may include the design, distribution or behaviour under stressed conditions of certain investment products; the activities or failure of a regulated entity; a market disruption; or an impairment of a market's integrity. Systemic risk can also be a gradual erosion of market trust caused by inadequate investor protection standards, enforcement, insufficient disclosure requirements, or inadequate resolution regimes.

Further reading

If you would like to learn more about our work, take a look at these documents available on our website:

- FMA Statement of Intent 2015-19
- FMA Annual Report 2016
- SRO 2015
- A Guide to the FMA's view of conduct[15]
- Annual KiwiSaver Report
- Investor Capability Strategy 2015-2018
- FMA Regulatory Response Guidelines, July 2016

15 fma.govt.nz/assets/Guidance/170202-A-guide-to-the-FMAs-view-of-conduct.pdf

FINANCIAL MARKETS AUTHORITY

TE MANA TATAI HOKOHOKO - NEW ZEALAND

AUCKLAND

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

Phone: +64 9 300 0400 Fax: +64 9 300 0499

WELLINGTON

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

Phone: +64 4 472 9830 Fax: +64 4 472 8076