Bank Conduct and Culture

Findings from an FMA and RBNZ review of conduct and culture in New Zealand retail banks

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FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

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Executive summary

Background

The Financial Markets Authority (FMA) and the Reserve Bank of New Zealand (RBNZ) have watched misconduct issues unfold in a number of jurisdictions, including the United Kingdom, United States and Australia. These misconduct issues are cause for concern, given that the development and maintenance of consumer and investor trust in the financial system is critical to its functioning.

In Australia, a range of issues with the behaviour of financial service providers led to the establishment of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (ARC). The ARC has highlighted failings in the treatment of customers across different parts of Australia's financial services industry.

New Zealand's four largest banks are Australian-owned, so the early findings of the ARC raise questions as to whether the same failings exist here also.

The ARC has been testing banks against 'community expectations' rather than solely breaches of the law. While this term itself is challenging to define, public expectations of financial services providers have changed since the global financial crisis and we are concerned that banks in New Zealand have been slow to react.

We have seen some examples in the past of banks in New Zealand treating customers poorly, for example, mis-selling of interest rate swaps. As such, we have reason to challenge the depth and pace of work within banks to build controls, processes, and training that support appropriate bank conduct.

The FMA and RBNZ want to ensure that sufficient levels of consumer confidence exist in the New Zealand financial system, and that this confidence is both justified and sustainable.

Purpose

The overall objective of this review was to understand whether there are widespread conduct and culture issues present in banks in New Zealand.

The conduct of banks directly affects customers. High standards of conduct support the fair, sound, efficient and transparent delivery of banking products and services, as well as confident participation by retail customers, businesses and investors in banking. Poor conduct is a contributing factor to poor customer outcomes and loss of trust in the banking system, and can be associated with other banking risks.

One of the key drivers of conduct is a bank's culture. Culture influences how management and staff behave on a daily basis. An effective culture within banks includes consistently putting customers at the centre of decision-making, product design, sales and advice processes, and all day-to-day activities.

The FMA and RBNZ are New Zealand's two main regulators of financial markets. The FMA focuses on conduct regulation of some financial market participants, and the RBNZ focuses on maintaining a sound and efficient financial system through prudential regulation.

Neither regulator has a direct legislative mandate for regulating the conduct of providers of core retail banking services (lending, credit, bank accounts). However, standards of banking conduct are important to the statutory purpose of both regulators, so we decided to test both directly with the banks and with key banking sector stakeholders whether or not there are widespread conduct and culture issues present in New Zealand banks.

Our work set out to assess the maturity of systems, controls and governance around conduct risks within the sector. We decided to focus our review on retail banking services, as these are used by nearly all New Zealanders.

What we reviewed

We reviewed New Zealand's 11 largest retail banks (see page 35) over a four-month period, to identify conduct and culture issues and risks that may be present locally, and to understand how banks detect, manage and remediate these.

Our review was based on interviews with bank staff and directors, and documents supplied to us by the banks. The review was not an audit of individual files or accounts, or a detailed investigation of historical cases like that of the ARC. We assessed the information that was provided directly to us by banks, and tested this in our onsite reviews. Banks were generally open, engaged and cooperative throughout the process.

We also sought insights from other banking industry stakeholders (see page 30) and conducted a consumer survey (see page 18).

In this report, we do not attribute findings to individual banks, because our focus is on the industry as a whole. However, we do draw some conclusions in relation to large banks and small banks. The four largest banks (ANZ, ASB, BNZ and Westpac), which we refer to collectively as 'large banks', each have a market share of at least 14%. All of the other banks, collectively referred to as 'small banks', each have a market share of less than 8%.

We also considered whether there are gaps in the framework for the regulation of retail banking services that may undermine the effectiveness or efficiency of conduct supervision or regulation.

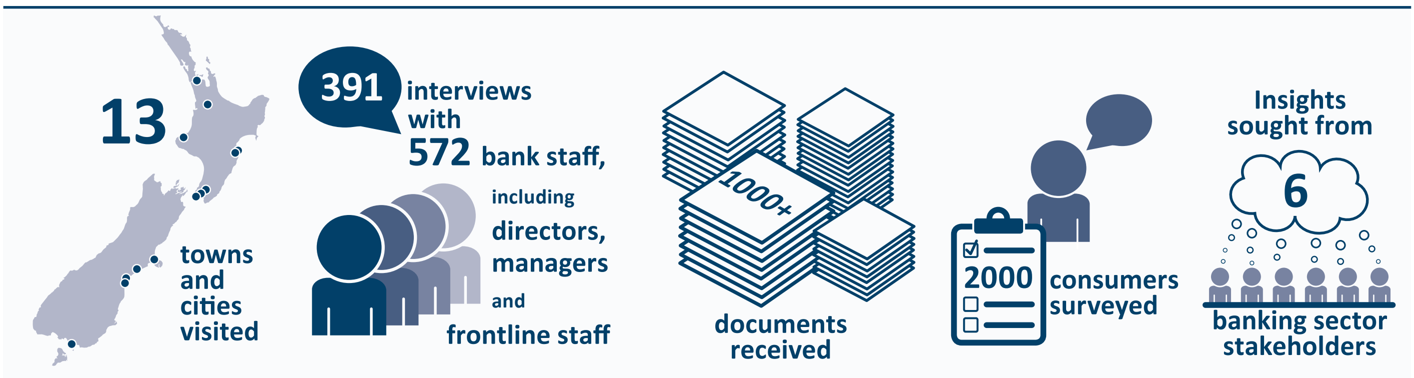
Our view of banks' conduct and culture

Our review found a small number of issues related to poor conduct by bank staff. Issues relating to system or process weaknesses were more commonplace. Based on these findings, conduct and culture issues do not appear to be widespread in banks in New Zealand at this point in time. However, we are concerned about banks' lack of proactivity in identifying and remediating conduct issues and risks in their business. More broadly, we identified weaknesses in the governance and management of conduct risks. This is a vulnerability that, if left unchecked, has the potential to lead to widespread issues.

We make a number of recommendations to improve oversight, controls and processes. Boards and senior management need to ensure these improvements are made with a sense of urgency. However, these measures will prove unsustainable if a bank does not have a truly customer-focused culture.

Banks have started to consider culture and conduct issues, but this work has generally been slow and relatively recent, and mainly in response to overseas events. Most of the initiatives we have seen only begin to address issues and risks, and do not go deep enough.

We recognise that banks are commercial enterprises that sell products and services to customers to make a profit and deliver returns to shareholders. We also believe that sustainable profitability (and a sound financial system) is best achieved when customers understand the banking products and services they



receive, and these are suited to their needs on an ongoing basis. In the absence of these criteria, customer confidence declines, as does bank profitability and financial system soundness and efficiency. The recent Global Financial Crisis is an extreme example of a lack of customer knowledge contributing to systemic collapse.

Most banks are at an early stage in embedding the necessary focus on long-term customer outcomes into their business strategy. Boards and management should be focusing on generating long-term sustainable profits, not maximising short-term profits at the expense of good customer outcomes.

Public expectations of our financial services industry have shifted. To maintain trust and confidence in our financial institutions and systems, banks need to think and act beyond minimum legal and regulatory standards, and champion business models that focus on customer interests.

We acknowledge that managing and measuring conduct is still relatively new for most financial service providers. Conduct risk and customer outcomes are less easily quantified than credit risk or market risk, and are not easily controlled by standard compliance tools. This is why the culture created by those who lead financial services providers is so important.

Our view is that New Zealand retail banks are well positioned to make the changes required. The nature of our banking sector and the lessons from international events means they can be responsive and lead cultural change within their institutions and as an industry.

Following this report, we will be expecting to see much deeper accountability of boards, executives and senior managers. We will be looking for progress and clear evidence of change, and want to see this become part of the ethos of all banks in New Zealand.

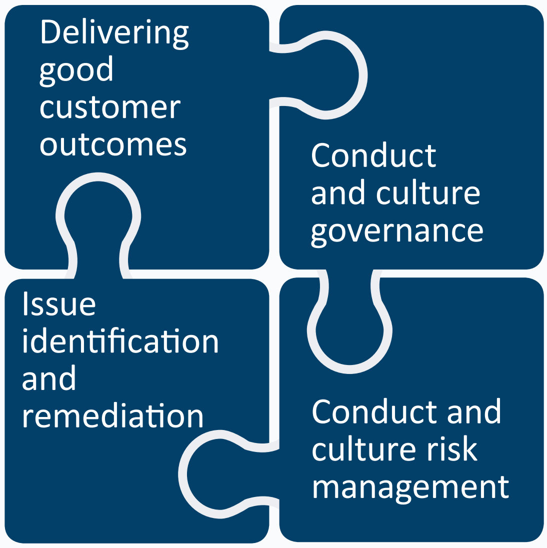
What we found

Conduct and culture of banks

Our review found significant variation in the maturity of banks' approaches to identifying, managing and remediating conduct risks and issues. While some banks have been thinking about conduct and culture for some time prior to our review, the approach of others can be described as reactive at best, and complacent at worst.

Overall, there are weaknesses in the governance and management of conduct risks, and significant gaps in the measurement and reporting of customer outcomes. These weaknesses leave New Zealand banks vulnerable to misconduct and to the issues seen in other jurisdictions.

We have divided our findings into themes based on four elements of managing conduct and culture.



1. Delivering good customer outcomes

- Staff in many banks felt a strong connection to their community, which contributed to a strong desire to do the right thing by their customers. However, reliance on this culture alone is insufficient to insulate against conduct risks. In some banks, messages about expectations for good conduct from the board, CEO or other senior leaders did not always appear to be reaching frontline staff, or mixed messages were being received.

- Some banks had incorporated a strong customer focus into their product design, product management and sales processes.
- Banks typically measured short-term customer satisfaction, but overall were doing very little to monitor long-term customer outcomes – that is, whether products purchased are suitable for customers' ongoing needs.
- The risk of poor customer outcomes was increased by the incentives offered to staff, which are typically highly focused on sales performance. Many banks are in the process of making significant changes to their incentive structures, although none go as far as we consider necessary.

2. Conduct and culture governance

- While the larger banks generally had more developed and longer-standing governance structures for overseeing conduct risks, this was a much newer focus for most of the smaller banks.
- Reporting to senior management and boards about conduct risks and issues was at an early stage of maturity in most banks. Where boards were receiving information about conduct, the content and frequency was insufficient to form a complete picture. There was a heavy reliance on 'lag' indicators (measuring conduct issues that have already occurred), rather than proactive 'lead' indicators (tracking trends that may identify future issues).

3. Conduct and culture risk management

- Across all banks there was variability in the quality of conduct and culture risk management. Some banks had positive initiatives and structures in place, or were well advanced with planning improvements. Other banks still have significant work to do.
- Only six of the eleven banks had analysed their conduct and associated risk frameworks against the FMA's 2017 Conduct Guide (see page 9) prior to our review. This was despite such analysis being strongly encouraged when the guide was published. In some cases, banks appeared to be taking action only because of our review.
- Across the industry, formal policies and procedures to encourage staff to report conduct and culture issues were not effective and seldom used. There was also a general lack of awareness and understanding of both formal and informal reporting channels.
- We identified gaps in staff training across many banks.

4. Issue identification and remediation

- Many banks relied on customer complaints to identify issues, but in some cases the systems and processes for recording complaints had serious weaknesses. Processes for staff to raise issues were also generally poor. Combined, these factors limited the ability of banks to identify and deal with issues in a timely manner. In some instances, banks had not approached remediation of identified issues with a sense of urgency.
- Our review identified conduct issues that banks are in the process of assessing and remediating (see page 27). The majority of issues stemmed from weaknesses in systems and processes, and resulted in impacts such as customers being charged incorrect fees or interest. In some cases, these issues affected large numbers of customers, although the average financial impact for each customer is estimated to be small.
- We observed a small number of issues that were primarily the result of poor conduct of bank staff, rather than system or process weaknesses (see page 28). Some of these related to inappropriate lending and sales, fees materially outweighing benefits to customers, manipulation of customer records to influence satisfaction outcomes, and manipulation of branch sales records. While we didn't find evidence to support these issues being widespread, we expect more issues may come to light as banks continue their own work in response to issues arising from the ARC.

Regulatory system gaps

There is a lack of specific regulatory requirements in relation to conduct across the banking sector, particularly in respect of the delivery of banking products distributed without financial advice. The FMA has used its legislated authority to impose governance and conduct requirements on the firms, or parts of firms, it licenses. We also used the current international focus on banking conduct and the RBNZ's general responsibilities for overseeing governance and risk management as the impetus for this review. However, neither regulator has an express mandate to regulate overall bank conduct.

While the current regulatory settings affect our ability to enforce change in governance and management frameworks for conduct risk, the issues identified in this review are not the result of gaps in regulation. The power to make changes rests with the banks, and their desire to change should come from a genuine focus on improving customer outcomes – not the need to comply with the law.

See 'Gaps in the regulatory environment' (page 31) for further explanation.

Next steps

We will be providing specific detailed findings to individual banks, along with our general observations, so they can understand what issues they need to address and what improvements they need to make. Each bank will need to develop a plan to address our feedback (see 'Recommendations for banks' on page 10), and report their progress to us by the end of March 2019. Banks need to place a high priority on the development and implementation of these plans.

Any remediation issues that warrant further investigation and potential enforcement action will be considered by the FMA, RBNZ or the Commerce Commission, depending on who is responsible for the legislation relevant to the issue.

We also want to address regulatory settings, to enable us to respond more effectively to retail banking misconduct and its drivers. We are recommending that the Government look at options for addressing the current framework.

What is conduct and culture?

At its most basic level, conduct is how people behave. Standards, systems, processes and controls are all necessary, but they are predictable and can be exploited by inappropriate behaviour.

From our perspective, culture refers to the shared behaviours, values and norms of the individuals and groups within an organisation. A bank's culture is one of the key drivers of its conduct. It also influences how people identify, understand, discuss and act on the risks that the organisation faces.

What does 'good' conduct and culture look like?

When we think about what 'good' looks like, we look at bank behaviour from the point of view of customers. Therefore, good conduct aims to achieve good outcomes for customers. This does not mean customers are insulated from risk, especially investment risk, or that they are not responsible for their own decisions. It means the product or service is understood by the customer, and is suited to their needs on an ongoing basis.

A healthy culture is one where staff are encouraged and expected to behave in a way that improves customer outcomes.

Setting and embedding corporate values is the role of boards and management, not the regulators. However, there are broadly applicable principles that should underpin the culture of all banks.

Following public consultation, the FMA published "A guide to the FMA's view of conduct" (FMA Conduct Guide) in February 2017. This contains guidance relevant to all financial service providers (even those not licensed by the FMA) and includes this profile of good conduct shown here.

We expect financial service providers, including banks, to have compared their conduct to the principles in the FMA Conduct Guide and taken action where their conduct falls short of what is set out in the guide. This expectation was widely communicated at the time the guide was published.

Recommendations for banks

Our review confirmed that all 11 banks need to more effectively identify, manage, remediate and report on conduct risks and issues, to deliver consistently good outcomes for customers. Banks need to proactively work to achieve maturity in this area.

We will be providing individual feedback that is specific to each bank, along with our general observations. Each bank will need to provide us with their plan to address our feedback by the end of March 2019, and then report to us on their progress implementing the plan. We will monitor progress, and take further action if we are not satisfied with the outcome or level of urgency.

There are five key aspects of our findings and recommendations that are common to all banks, and should form the basis of their plans.

All financial services providers, including those operating in the wholesale space, would also benefit from assessing their conduct against these themes.

Board ownership and accountability for conduct and culture

- Boards need to take ownership for driving change in conduct and culture within their bank. They must be proactive in considering what information they require to obtain assurance of good customer outcomes. Boards need to clearly direct management to devise frameworks and metrics, and collect information that gives a good indication of customer outcomes and standards of conduct.
- Measurement and reporting on conduct and culture should include both 'lead' and 'lag' indicators, so banks can monitor and mitigate emerging risks, as well as identify misconduct that has already taken place. Banks cannot rely on the absence of identified issues as an indicator of good conduct.
- Banks need to review how they define and record customer complaints, and make it easy for customers to raise concerns.

Identify and remediate issues

- Banks need to be proactive about identifying and remediating issues. Remediation should always be prioritised – which we have seen is not always the case.
- We expect all banks to review their conduct and culture against relevant issues arising from the ARC. This work should be adequately resourced and given high priority.
- Where banks have not identified any issues requiring remediation, bank boards and senior management need to seriously challenge whether this is because there are no issues, or because there are weaknesses in the processes and systems for identifying and recording issues.

Strengthen processes and controls

- Many issues we have seen appear to have stemmed from weaknesses in systems and processes. All banks need to focus on strengthening the frameworks, processes and controls that prevent, detect and manage conduct and culture issues. This will require prioritising investment, and should be an area of ongoing focus for banks beyond the conclusion of this review.

Staff reporting channels

- Banks need to educate their staff on what good conduct and culture looks like, and have effective mechanisms for staff to report deviations from this. Formal whistleblower policies and other less-formal reporting channels need to be accessible, confidential and comprehensive enough to identify conduct and culture issues.

Incentives

- Banks' incentive structures need to be designed and controlled in ways that sustain good customer outcomes. Removing incentives linked to sales measures[1] is a significant step toward this goal. We expect banks to revise their sales incentive structures for frontline salespeople and through all layers of management. Most banks have acknowledged the need to make significant changes to their incentive schemes. Progress appears to be in a positive direction, with banks generally reducing the focus on sales performance. However, none of the changes announced by banks to date go far enough to create a sustainable culture of good conduct.
- We expect banks to implement changes to their incentives programmes no later than the first performance year after 30 September 2019. In March 2019, we will ask all banks how they will meet our expectations regarding incentives, and we will report on their responses. Any bank that does not, at that date, commit to removing sales incentives for salespeople and their managers will be required to explain how they will strengthen their control systems to sufficiently address the risks of poor conduct that arise with such incentives.

Good conduct is not an outcome that can be achieved at a point in time before moving on to other initiatives. As conduct is driven by behaviour, it requires ongoing focus and dedicated resources. Senior management and boards need to take ownership for improving conduct and culture.

A bank's approach to conduct risk needs to reflect its business model, customers and environment. The management of conduct risk also needs to be prioritised across the organisation, to minimise negative outcomes for customers.

This approach, if led from the top and embedded across all areas of the business, will ultimately generate an organisation-wide culture of prioritising good customer outcomes and fostering continuous improvement in this area.

Conflicts of interest

There are inherent conflicts of interest in the provision of financial services. This is particularly apparent in vertically or horizontally integrated firms such as banks, which both 'manufacture' financial products, and provide advice and sales. We have seen these conflicts play out in the design of sales incentives, and in the lack of investment in systems and processes for measuring and reporting on customer outcomes.

There are also significant information asymmetries where customers have to rely on bank staff to give them all the information they need. Bank directors, management and staff need to recognise and manage these conflicts and asymmetries, and work constantly to ensure customers are offered products that are best suited to their needs, both at the time of sale and in the long term.

1. We define sales measures as measures that are achieved by retail customer sales or referrals, whether at an individual or team level. This includes sales/referrals numbers, sales value and asset or liability growth.

Detailed findings

Delivering good customer outcomes

Delivering good customer outcomes is about how the bank has embedded a customer-centric perspective in the design and delivery of their products and services to ensure customers understand the products and services they are receiving, and that these are appropriate for them on an ongoing basis.

What we looked for

- Do processes for product design and sales help ensure customers are provided with products that are suitable and easy to understand?
- Do incentives and remuneration encourage staff to prioritise good customer outcomes?
- Is the bank's communication with customers clear, transparent, fair, timely and consistent?
- Does the bank seek customer feedback and measure customer outcomes over both the short term and long term?
- Is there ongoing post-sale review of customer needs?
- Is the behaviour of frontline sales teams consistent with the tone set by the Board, CEO and senior management?

Our findings

We found that, while some banks are already incorporating a strong customer focus into their product design, sales processes and how they treat vulnerable customers, significant progress is required in these areas by all banks. Across the banks, there is a significant gap in the measurement and reporting of customer outcomes. Incentives offered to sales staff are typically highly focused on driving sales, which increases the risks of poor conduct.

Product design and management

To ensure good customer outcomes, banks need to make customers the central consideration of their product design and management processes. In practice, this should include the following:

- Learning what products customers need, then designing products that meet those needs.
- Monitoring what types of customers are purchasing the products and how customers use products, and taking action when products are being used in an unintended way or do not have the intended outcomes.
- Reviewing products regularly to ensure they still meet customer needs, and seeking to improve products to align with changing expectations.
- Adequate board oversight of, and accountability for, product design and management.

We found variability in the processes banks have in place for designing products. Our observations of how banks are measuring customer outcomes from those products is covered in a separate section below.

Some banks have well-structured product design and review processes. By making customers the central focus of product design, banks increase the potential for their products to truly meet customer needs. In these cases, banks use research and insights to better understand customers and their needs when developing products.

To ensure a focus on customer needs, some banks have collaborative product design processes involving product, marketing, digital, risk and legal staff. In contrast, some banks do not have formal processes for considering customer needs in the product design process. Finding a way to hear the 'voice of the customer' is critical in the design of products.

Many of the banks regularly review their products to ensure they operate as intended and meet customer needs. Several banks have withdrawn, amended or replaced products as a result of issues that they identified, or in response to external events.

However, some banks' product review processes were primarily focused on how the product benefits the bank, rather than customers. This reduces the likelihood that key risks posed by the products will be detected and remediated.

Some banks have product simplification projects underway. Complex products pose a risk because they are more difficult for customers to understand and use. Having a large number of similar products available can also cause confusion for customers. These banks are actively working on reducing the number of products they have, and simplifying product features. Changes made by banks in this area include simplifying or removing fees, designing a basic credit card with minimal features in response to customer feedback, and making product rules fairer.

The product design and management improvements we have seen are generally positive. However, all banks need to regularly review their products to ensure they continue to be easily understandable and suitable for customers.

Sales and advice

Our consumer survey found 82% of respondents agreed that their bank had listened to their needs. However, customers generally have a lot less knowledge and understanding of bank products than bank staff. This 'information asymmetry' means that when a customer receives information or advice from bank staff that results in the purchase of a product, they may not be able to tell if the information or advice aligns with their needs. When bank staff are incentivised to prioritise sales over good customer outcomes, this risk is heightened. We received some reports of staff feeling pressure to sell (which can lead to customers feeling pressured to purchase), and some reports that this was not the case.

Most banks have a process or system to guide conversations that staff have with customers, and to help staff identify and meet customer needs. Some of these processes are described by the banks as focusing on customer needs, but still appear to have the primary goal of selling a product to the customer.

Staff at one bank shared several positive examples where they have declined credit – for example, a loan or credit card – because the product was not right for the customer. This bank trains its staff on how to have a conversation with a customer about the decision to decline credit and help the customer make a plan to obtain the credit as, and when, it is best for their needs.

Customers should receive products that meet their needs and are affordable. Banks typically have systems and processes to control what staff can sell or approve, including the amount and type of lending. Some banks have centralised their credit approval functions or automated their decision processes, so that staff who provide advice or sell products to customers are not involved in decisions about providing credit. Other controls are system-related, such as those that prevent falsifying loan application details to obtain approval.

In contrast, some banks told us that while staff are expected to act within approved limits and policies, the system does not prevent them from selling or approving products that are outside their area of responsibility. This is indicative of a weak risk-control framework. In other cases, checks and controls to detect deviations are not sufficiently thorough or consistent. This means that inappropriate sales and lending may not be detected in a timely manner, increasing the potential for harm.

We expect banks' systems to comply with internal and external requirements and policies. Banks must ensure their products operate as intended. This includes having appropriate controls to prevent errors, breaches of approved limits or deliberate misuse of systems and products. Management also needs to have the ability to monitor and review the quality of conversations between staff and customers.

We also expect banks to adopt a risk-based approach to sales and advice. We did not undertake a detailed investigation of how banks ensure that products and services, including lending, are suitable for their customers. The ARC interim report highlighted weaknesses in Australian banks' processes for investigating and verifying the financial position of their customers in credit assessments. In particular, concerns were raised about Australian banks' reliance on minimum expenditure benchmarks, rather than estimating actual customer expenditure.

Some banks in our review indicated that their credit assessments incorporate whichever is higher of estimated customer expenses or a minimum expenditure benchmark. However, we did not get a good sense of how many loans are approved using these minimum expenditure benchmarks, and how realistic these minimum benchmarks are. We will share information that relates to the banks' adherence to the Responsible Lending Principles with the Commerce Commission for their consideration. Reflecting its prudential mandate, the RBNZ will review banks' lending standards in due course.

Some banks acknowledged challenges with monitoring and managing the conduct of intermediaries. A number of banks highlighted conduct risks associated with their limited oversight of the customer interactions that occur through brokers and other intermediaries. The ARC interim report highlighted concerns about the roles and responsibilities of intermediaries, in particular whether the intermediary acts in the interest of the customer or the bank, and how the remuneration of intermediaries impacts customer outcomes. While again our review was limited in this area, we found little evidence of banks having enhanced controls and oversight of their higher-risk products and distribution channels.

More work is required to ensure banks are comfortable with the quality of conversations and advice that occur via intermediary channels, and that the incentives offered to intermediaries are aligned with good customer outcomes.

Incentives

How people are incentivised influences the way they act and tells them what behaviour is valued. In banks, incentives that are linked to sales encourage staff to sell products and tell them that a sale is a good outcome. This creates a conflict of interest between the staff member and the customer, as it is not always in the interest of customers to buy products. Banks need to manage this conflict of interest to ensure good customer outcomes.

The FMA has undertaken a separate thematic review[2] of the incentive structures of nine of the 11 banks covered by this review[3]. It found that incentives schemes in place are highly sales focused, with sales performance typically determining the majority of a salesperson's variable pay, and schemes structured to encourage high sales performance.

Given incentive schemes are highly sales focused, controls to effectively manage the risk of inappropriate sales are crucial. The review of bank incentives found that controls are designed and conducted in a way that

2. The findings of this review will be published by the FMA in November 2018.
3. HSBC and Rabobank were not included in the review of bank incentive structures.

means they are unlikely to be effective at identifying inappropriate sales. Many of the controls address other risks, such as manipulation of sales data by staff, poor customer experience and poor record-keeping. These may inadvertently identify poor customer outcomes, but they do not directly and systematically identify inappropriate sales.

Banks need to determine the most appropriate way to design and control incentive structures to sustain good customer outcomes. Removing incentives linked to sales measures is a significant step toward this goal. We expect banks to revise their sales incentive structures for frontline salespeople and through all layers of management. Most banks have acknowledged the need to make significant changes to their incentive schemes. Progress appears to be in a positive direction, with banks generally reducing the focus on sales performance. However, none of the changes announced by banks to date go far enough to create a sustainable culture of good conduct.

Following the release of the findings on incentive structures, we expect banks to implement changes to their incentives programmes no later than the first performance year after 30 September 2019. In March 2019 we will ask all banks how they will meet our expectations regarding incentives, and we will report on their responses. Any bank that does not, at that date, commit to removing sales incentives for salespeople and their managers will be required to explain how they will strengthen their control systems sufficiently to address the risks of poor conduct that arise with such incentives.

Measuring customer outcomes

We expect banks to obtain feedback from customers, and seek to understand if customers are receiving good outcomes from their products and services.

We saw banks use measures such as customer surveys, mystery shopping, monitoring of social media, and meetings between customers and senior management to obtain feedback. One bank obtained feedback at customer forums in different locations throughout New Zealand. Bank staff, management and board members attend these forums at least once a year to listen to feedback on the bank's products, services, and local community involvement.

While this is positive, the information we received about these feedback mechanisms largely suggests they measure customer satisfaction rather than customer outcomes.

Satisfaction generally refers to how pleased the customer is with their bank, and normally has a short-term focus. For example, a customer may be very satisfied with the service from their branch when applying for a loan, but if the loan is not suitable for their needs and results in financial hardship, the ultimate outcome is poor.

Measuring outcomes typically looks at the longer-term results, to see whether the value or benefit the customer receives is appropriate to the product, and understood by the customer.

Many banks used a survey tool known as 'Net Promoter Score', which gauges customer loyalty. These surveys are typically done immediately after the customer interacts with the bank. However, the harm caused by poor product design or inappropriate sales or advice may not manifest for years. We do not consider Net Promoter Score or other similar surveys sufficient to measure customer outcomes.

Overall, most banks did not appear to have structured processes and tools to measure customer outcomes over time. Some of the bank staff, management and directors we spoke to were not familiar with the difference between customer satisfaction and customer outcomes. Others understood the terms, but could not define what a good customer outcome would look like. It is difficult for banks to effectively measure and report on customer outcomes if they have not defined what 'good' looks like, or do not understand the difference between customer satisfaction and customer outcomes.

Some banks measured customer outcomes through Net Promoter Score only, or relied on the absence of complaints to indicate good outcomes.

Internal reviews of customer interactions and lending decisions also provided some insights about customer outcomes. However, these reviews often focused on compliance with internal policies, processes and rules, rather than whether the outcome was right for the customer. They were often not designed to measure longer-term outcomes. Additionally, most banks were not always capturing customer interactions in a way that enabled them to be reviewed later, further hindering the ability to gain assurance of good outcomes.

Some banks have started to make progress in this area. One bank is trialling the use of data analytics to assess customers' banking activity and identify if their current product is suitable for their needs, and if another product would better suit their situation. Another bank has indicated it is investing more time and resources in identifying customers who have purchased potentially unsuitable products or are using products in a way that is not intended by the bank. In some instances, these activities appeared to be one-off or ad-hoc, rather than part of an ongoing and systematic review of customer outcomes.

We expect management and boards to consider what good customer outcomes look like for different parts of their business – for example, products, customer segments, distribution channels – and measure how they are performing against that definition. Measurement is key: we expect all banks to undertake reviews to ensure customer outcomes are appropriate, and take action where they find customers experienced poor outcomes or may do so in the future.

Vulnerable customers

A theme that emerged from our review was how banks deal with vulnerable customers. We consider that how banks interact with vulnerable customers is one indicator of how customer-focused they are.

A "vulnerable consumer is someone who, due to their personal circumstances, is especially susceptible to detriment, particularly when a firm is not acting with appropriate levels of care"[4]. Circumstances may include low levels of literacy and numeracy, an inability to use the internet, illness or disability (including mental illness and dementia) and age.

Some external stakeholders who deal with vulnerable customers on a regular basis shared some of their observations:

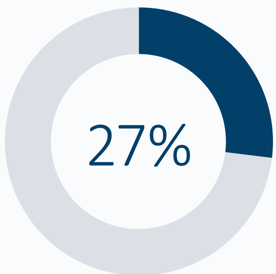
- Some low-income customers have difficulty opening accounts or obtaining lending from banks. Some external stakeholders suggested there are not sufficient or appropriate banking products and services that meet the needs of this group. This can lead to these customers using financial providers outside the banking system, which can result in them paying higher fees and interest rates.
- Vulnerable customers who are unable to use or access technology may have difficulty accessing banking services.

4. "Customer Vulnerability", paper published by the UK Financial Conduct Authority, 2015

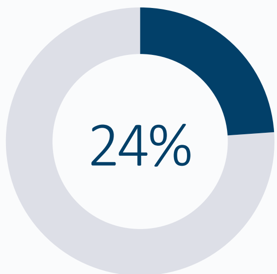
- Some retail customers, including vulnerable customers, have received offers of lending or credit products that are unaffordable. This includes unsolicited offers that do not take their personal circumstances into account. A survey earlier this year by Consumer NZ found 27% of people reported receiving unsolicited product offers from their bank. Similarly, our consumer survey found 24% of respondents had received an offer of a product they did not want or need. Stakeholders told us some customers have reported that they feel pressure to purchase products from their bank in these situations. This was supported by the results of our survey, where 15% reported feeling pressure from bank staff to purchase products they did not want or need.

Some banks told us about their initiatives in this area. One bank has trained staff to recognise, understand and respond to the needs of customers who are suffering from dementia. This bank has put processes and controls in place to meet the particular needs of dementia sufferers, who they perceive to be vulnerable.

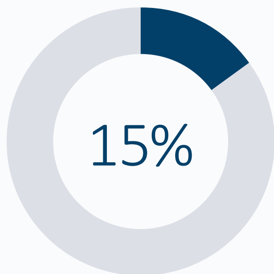
Another bank told us they are installing computers or mobile devices in public places (such as libraries or community facilities) in locations where there are no physical branches. However, based on the feedback from external stakeholders, technological alternatives are not suitable for some of the most vulnerable customers, who benefit from face-to-face interaction with bank staff. We encourage all banks to carefully consider the needs of all their customers, and look for ways to introduce, or change, banking services to accommodate vulnerable customers in a meaningful way.



of people reported receiving unsolicited offers of products from their bank[5]



of people had received an offer of a product that they did not want or need[6]



reported feeling pressure from bank staff to purchase products they did not want or need[6]

5. Source: 2018 Consumer NZ survey
6. Source: Consumer survey conducted as part of this review

Survey of bank customers

As part of this review, we commissioned a survey of 2,000 New Zealanders aged 18 and over. The survey asked about the quality of interactions and communications they have with their bank, their awareness and experience of their bank's complaint processes, and the level of trust that they have with their own bank and the banking industry as a whole.

The survey found that approximately two-thirds of people trust their own bank to meet their individual needs. However, only 42% of people trust the banking industry as a whole. Customers of smaller banks tend to have more trust in their own bank and less trust in the industry than customers of large banks.

69% of people agreed that bank staff tailor advice or recommendations to their needs, but only 44% felt bank staff put their long-term financial interests first.

24% of respondents agreed that their bank's staff had offered them products they didn't want or need. The results for individual banks ranged from 7% to 15% for small banks, and from 25% to 30% for large banks.

Following on from this, 15% of people agreed bank staff had tried to pressure them into buying unwanted financial products. The range of results for individual banks was again wide, ranging from 3% for one bank to 21% at another.

4% of people had made a complaint to their bank in the past year and an additional 6% said they had felt like making a complaint but decided it was too much effort.

The results of the survey will be published alongside this report.

Conduct and culture governance

Conduct and culture governance is the principles, practices and processes that determine how the bank's board of directors (board) and senior management oversee the management of conduct and culture issues and risks, to ensure alignment with the expectations they set.

What we looked for

- Do the board and senior management have a strong focus on conduct and culture issues?
- Is there a high level of board and senior management engagement and accountability via risk appetite statements, and regular comprehensive reporting?
- Does the board hold itself accountable for the culture of the organisation, including ensuring it has a customer focus and staff are comfortable escalating issues?
- Does the board consider the impact of the bank's strategy on its customers?
- Does the board hold itself accountable for incentive and remuneration structures?
- Are there appropriate management structures and committees in place to oversee conduct and culture issues?

Our findings

All banks need to improve their conduct governance. Although the boards of large banks have been thinking about conduct and culture for some time, relevant reporting to boards is weak, and the information that flows in both directions contains little about customer outcomes. Conduct and culture is generally a newer focus for the boards of most small banks.

Focus on conduct and culture

We saw a disparity between how boards in banks of different sizes oversaw conduct and culture issues and risks. The boards of the large banks were more aware of conduct and culture issues in other countries. Some banks started considering the implications of these issues as early as 2013.

The large banks typically undertook some type of internal review when the FMA published its Conduct Guide, and when the ARC commenced in late 2017. They were better placed to do these reviews because they had already had discussions about conduct issues.

In contrast, while the small banks generally demonstrated a customer-centric culture, their consideration of conduct issues began a lot more recently – in some instances only after we began this review.

The degree to which senior management focuses on conduct is likely related to how they are incentivised.

In all banks, a portion of the CEO's remuneration was linked to the performance and outcomes of the bank, such as financial performance, risk management, strategy and customer relations. At six of the 11 banks, approximately two-thirds of the total remuneration for the CEO was based on these variable components.

In some instances, incentives were linked only to short-term outcomes. This is likely to lead to short-term financial goals being prioritised over long-term customer outcomes. Even where CEO remuneration was linked to long-term outcomes, the measures mainly related to financial performance or parent bank considerations rather than customer outcomes or the behaviour of bank staff.

Boards need to set clear expectations for management about achieving good conduct and culture outcomes. Any incentives for senior management need to appropriately balance short-term and long-term outcomes, and be aligned to good outcomes for customers as well as shareholders.

All banks, regardless of their size, need to fully understand the environment they operate in, and learn from other banks, regulators, and their own information and experiences. This is essential for identifying emerging issues, and supporting an ongoing focus on good conduct and culture.

Conduct and culture reporting

While boards typically received data about a broad range of activities across their banks, reporting about conduct appeared to be at an early stage of maturity in most banks. Overall, we think boards require more information about conduct and culture to be able to understand the bank's performance and risks in these areas.

Where boards were receiving information about conduct, this was insufficient for directors to form a complete picture of conduct and culture issues present in the bank. The ARC has highlighted similar weaknesses in some Australian banks.

One bank told us they only reported the number of customer complaints; this is not enough for the board to form an adequate understanding of the status of conduct and culture across the organisation.

One board only received annual reporting on conduct. This is not frequent enough to identify trends and provide challenge or direction to management.

At another bank, conduct-related matters were reported to, and discussed at, several different forums and committees. However, there was no centralised reporting to senior management or the board, so the board was unlikely to have the information they needed. In another instance, a director told us that they did not receive the information they required from management. Boards must be able to satisfy themselves that they are receiving sufficient information from management, and be proactive about requesting what they need.

Across the industry, there appeared to be a heavy reliance on 'lag' indicators that report on historical information, such as customer complaints or satisfaction surveys. Banks were not using 'lead' indicators to any material degree. Lead indicators can provide insights on potential outcomes and identify emerging trends. For example, analysis of how a customer is using a product may be an indicator of outcomes such as whether the fees the customer is paying are reasonable, or whether they are receiving the intended benefits from the product.

Once boards are receiving the information they require, they must use this as an input for strategy setting, and to provide direction and guidance for management.

Oversight of conduct and culture

We looked at management structures, roles and committees for overseeing conduct and culture risks. All of the large banks had one or more committees, councils or forums to oversee the management of conduct. These were generally comprised of senior or executive management, and sometimes included subject matter experts from across the bank.

The function of these structures varied between banks. One bank had a committee responsible for ensuring the bank adheres to its conduct principles. Another established a conduct committee in 2015 to provide advice and support on conduct matters. Discussion at one committee resulted in material changes to new products before they were introduced, to address potential risks to customers.

The majority of these committees and councils were relatively new, and some have limited authority. It will take time for these structures to be embedded.

We saw several banks with new 'customer advocate' roles. These differed between banks, but generally focused on dealing with complex or widespread issues impacting customers, serious customer complaints, and providing guidance in relation to conduct.

These committees, councils and roles are useful to assist in preventing and managing conduct issues, and to show commitment to ongoing improvement of customer outcomes.

In general, the small banks have been slower to put these structures in place, although one small bank implemented a comprehensive conduct programme following a 2016 self-assessment of its conduct maturity.

Some small banks had not given any significant consideration to conduct risk (including how to monitor and manage it) prior to our review, and some did not believe they face conduct risks to any material degree. Some believe their strong customer-centric focus and ownership structure mean they do not face conduct risks in the same way and to the same degree as other banks.

However, all banks face risks, including conduct risks. These can stem from internal or external factors, including information asymmetries and conflicts of interest, and are often exposed through business growth and changes in products, services and personnel, and new customer segments. All banks need to establish appropriate internal roles or structures to manage risk, and ensure these have sufficient authority to have a material impact on the bank's conduct and culture.

Conduct and culture risk management

Conduct and culture risk management is the frameworks, practices and processes the bank has in place to manage conduct and culture issues and risks on a day-to-day basis.

What we looked for

- Are there well-defined roles and committees that are responsible for proactively identifying conduct and culture risks, and assessing and managing these risks?
- Does the bank have capable, well-trained staff who prioritise good customer outcomes?
- Does the bank's culture support staff to speak up and escalate conduct and culture issues to management and the board?
- Is there an effective whistleblower policy?
- Do policies and procedures have a customer focus?
- Does the bank have a fully functioning 'three lines of defence'[7] structure?
- Is the bank able to identify and manage conflicts of interest?

Our findings

Overall, we found variability in the frameworks in place to identify, assess and manage conduct and culture risks. In our view, there was a serious weakness in that the policies to encourage staff to speak up about conduct and culture issues were not effective. Most banks need to prioritise making changes to their formal and informal reporting channels. We also see the opportunity for improvements to staff training.

Risk frameworks

A structured approach to risk management can assist banks to proactively identify, assess, mitigate and avoid risks, and increase the chance of an effective response to issues. However, this approach does not necessarily mean conduct and culture risk management is well embedded.

We saw some good, albeit early-stage, examples of banks making progress in managing conduct and culture risk. The large banks typically had more sophisticated risk management committees and frameworks, but this was in proportion to their generally more complex organisation structures and product suites.

One bank's conduct committee had a positive influence in addressing potential risks to customers, but did not approve new products or have formal decision-making powers, so its views could be overridden. Banks need to identify and fix gaps such as this in their frameworks.

Management structures and roles to support conduct and culture must be adequately resourced and have an appropriate level of authority. The authority of a committee or role reflects the importance the bank places on its functions.

We saw different approaches to how banks identify and position conduct risk within their risk frameworks, including:

- Identifying conduct risk as a separate category, with specific conduct risks listed.
- Identifying conduct risk as relevant to all categories of risk, rather than being a separate category.
  - Some banks took this approach after carefully

7. 'Three lines of defence' is a model that banks and other entities use to structure their risk and compliance assurance and oversight functions. The first line of defence is the teams and departments that carry out the bank's business; they are responsible for managing the risks associated with those activities. The second line of defence is oversight functions (such as risk and compliance teams) who set direction, define policies and procedures, and provide guidance and challenge to the first line. The third line of defence is independent oversight (such as audit) of the assurance provided by business operations and oversight functions.

considering how to best identify and manage conduct risk within their overall risk management framework.

  - Some banks appear to have taken this approach by default because they have not given specific consideration to conduct risk. Some banks did not even believe they face conduct risk, which limits their ability to identify risks and respond appropriately.

- Relying on lag indicators, which alone are insufficient due to their backward-looking nature. Some banks had separately defined these indicators in their risk appetite statements[8], while others had not measured conduct in a systematic or coordinated way.

We do not prescribe how banks should position conduct risk – the key issue is how they identify and manage it. All banks need to consider how their risk-management framework supports the identification, recording, management, measurement and reporting of conduct and culture risks. Each bank's approach should be appropriate to its size, product and customer mix, culture and strategy.

Reporting and escalation of issues

Having safe and confidential mechanisms to encourage staff to report issues or concerns is a key part of a healthy culture. All banks had policies or procedures to outline the processes and protections for staff who wish to report serious wrongdoing or misconduct, commonly known as 'whistleblowing'.

We found whistleblower policies were not always well understood by staff. In the majority of banks, staff rarely use the formal reporting mechanisms. This suggests whistleblower policies are not particularly effective in encouraging staff to speak up about issues they may encounter on a day-to-day basis.

Some issues that may discourage staff from formally reporting issues are:

- Limited staff awareness and understanding about whistleblower policies, including lack of awareness that the policy provides a safe option for reporting. In some cases this was due to a lack of training.
- Concerns about confidentiality or the bank's protection mechanisms, potentially due to a lack of independence in the reporting channel.
- The whistleblower policy was positioned as being for only the most serious misconduct cases.
- Some policies were not customised for the New Zealand environment, meaning staff found it difficult to relate to and understand the protections of the policy.

We also looked at less-formal reporting mechanisms. Many of the banks had strived to create an environment where staff felt comfortable talking to a manager, the human resources team, the risk team, or other staff if they had any concerns about conduct and culture.

Many of the staff we interviewed said they would feel comfortable raising concerns and issues in this way. However, most banks were unable to provide evidence of staff using informal channels. If issues are being raised in this way, they are generally not being documented. This means identifying trends becomes more difficult, and serious issues may be overlooked.

We are concerned that these mechanisms are not an effective source of information about the conduct issues banks need to address. Staff are a rich source of ideas and feedback that can lead to improvements in customer outcomes, so it is important that banks can receive and act on this feedback.

We expect banks to foster a 'no-blame, speak-up' culture. Formal and less-formal reporting channels need to be visible to staff, to provide for independent, confidential and effective reporting. Banks also need to educate their staff about expectations of good

8. A risk appetite statement is an agreed statement by the board or management regarding how much of different types of risk the bank is willing to take when seeking to achieve their objectives.

conduct and culture, so staff can recognise and report deviations.

The escalation of issues to senior management and boards was also the focus of our attention. Some banks failed to adequately report conduct and culture issues to the board, as shown by the following examples:

- A director at one bank told us that 'bad news' information has historically been slow to flow up to the board.
- At two banks, management told us about a historical conduct incident that was not reported to the board, as it was determined to be not sufficiently material. However, in both of these cases a director told us it was the type of issue they would expect to be informed about.

We acknowledge that it is not possible or appropriate for boards to be notified about all operational issues. Banks need to determine which issues warrant board attention. Management needs to be open and transparent, and not conceal or minimise issues that have the potential to result in harm to the bank or customers. Boards need to take ownership of good customer outcomes and set expectations for management to deliver, measure and report on this.

Staff training

Capable, well-trained staff contribute to good conduct and culture within a bank. All banks have different training programmes, such as on-the-job training, more structured electronic learning or facilitator-led courses, or a combination of these.

Some of the staff we talked to expressed concern that the training was sometimes insufficient to fully understand the bank's products and systems, particularly for new staff. It appeared that some banks invest heavily in training and support for staff, while this is less of a priority in other banks.

Examples of some areas for improvement in relation to training and support include:

- Staff training in retail branches appeared to be less structured and less comprehensive than training for staff in telephone-based contact centres. Additionally, contact centres had more tools for oversight and coaching of staff, such as recording phone conversations.
- Most banks used electronic learning courses for staff to complete at their own pace. While these are useful, a lack of discussion and interaction during training can result in key messages being misinterpreted or overlooked.
- At one bank, staff told us they felt they did not receive sufficient training on the core aspects of their role, and we observed an expectation from management that new staff are recruited with all the required skills already in place.

In contrast, other banks provide a significant amount of training and support, going beyond the usual training topics and methods to ensure staff are well-supported in meeting customer needs:

- One bank had a dedicated team of experienced bankers who are available for frontline branch staff to call if they have a specific query, ensuring quicker resolution of customer needs.
- One bank was working with an external party to develop a formal accreditation programme for staff, aligned to the bank's conduct principles, to help staff focus on delivering fair, clear and suitable outcomes for customers.

When there are weaknesses in staff understanding of the bank's products or expected behaviours, the potential for customer harm is increased. We strongly encourage all banks to review the content and delivery method of training to ensure these are appropriate to support staff in delivering good outcomes for customers.

Issue identification and remediation

Issue identification and remediation is about how the bank identifies and manages conduct and culture issues and risks.

What we looked for

- Were there appropriate, timely processes in place to identify conduct and culture issues and risks?
- Was there evidence that issues requiring remediation are dealt with appropriately and in a timely manner?
- Were remediation processes clear and understood by all parties?
- Did the bank undertake root-cause analysis of complaints, and appropriately record and escalate issues?
- Was there evidence that broader consequences identified in root-cause analysis were assessed, and influenced the bank's remediation framework?
- Was there evidence that remediation activities were achieving good customer outcomes?

Our findings

Overall, we found variability in the processes banks have in place to identify and remediate issues. Many banks require improvements. There are a number of issues being remediated (or requiring remediation), primarily related to system or process issues. There are also significant work programmes underway in some banks to identify whether key issues arising from the ARC are also present in their own business. These may identify more issues that require remediation.

How banks identify issues

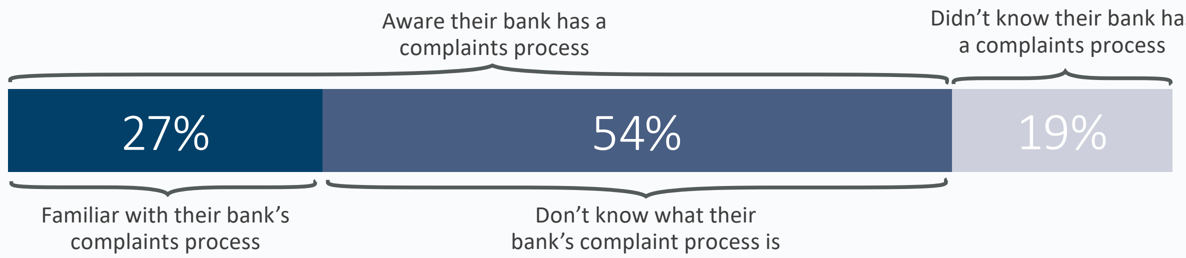
Most banks do not have comprehensive processes to systematically and proactively identify potential or emerging issues. To a degree, they rely on complaints from customers to identify issues. Our consumer survey showed that only 4% of those surveyed had made a complaint to their bank in the past year. Relying on complaints is likely to be insufficient to identify all potential issues requiring remediation.

All the banks had processes for recording and dealing with customer complaints; there was variation between banks in terms of how effective these were.

In some instances, bank staff were not recording complaints they could resolve quickly, and only recorded complaints requiring further investigation and action to resolve. The risk with this approach is that emerging trends – such as where a number of complaints received in different branches relate to a similar issue – may not be detected in a timely manner, or at all. This reduces the chance for the bank to address the root cause. Banks need to develop a 'no-blame' culture around customer complaints, to ensure staff feel comfortable raising and recording issues.

Despite documented policies and procedures, in some banks complaint processes did not appear to be implemented consistently, potentially due to deficiencies with training and supervision. Our survey

Customer awareness of the complaints process



of New Zealanders found that 81% of those surveyed knew their bank had a complaints process, but over half were not familiar with it. We would like to see banks encourage and empower customers to make complaints.

In an example of poor conduct we observed at one bank, some staff were not recording complaints that were resolved quickly, complaints they believed were unjustified, or complaints where they considered a breach of bank policy had not occurred. In instances such as this, there is a risk that complaints may not be resolved to the customer's satisfaction, and bank management will not have access to reliable information on the volume or types of complaints.

We expect banks to undertake proper root-cause analysis of complaints to understand the underlying cause, and to determine how widespread the issue is. We saw some examples of good practice in this area. One bank told us that if an issue affects ten or more customers, it is escalated to a team of staff from different parts of the bank. That team assesses the incident, including how widespread it is, and ensures appropriate actions are taken to minimise the impact on customers and the bank. Issues of a serious nature are reported to senior management and the board.

Some banks do not have robust systems for recording complaints, which can hinder the ability of root-cause analysis to detect themes and confirm that complaints are being resolved satisfactorily and within appropriate timeframes. For example, several banks have systems and processes that are difficult for staff to use, which in some cases discouraged staff from recording customers' complaints.

We also saw processes that made it difficult for customers to formally report a complaint – for example, requiring a customer to file a written complaint, even if they were at a branch. This finding was supported by our survey, where 8% of respondents said they wanted to make a complaint but didn't know how or found it too difficult.

Additionally, without a full and reliable record of a customer's interactions with the bank, resolution of a complaint may take longer or result in a poor outcome for the customer. External stakeholders told us they have encountered situations where poor record-keeping resulted in difficulties with resolving complaints.

There is no common definition across the banking industry of what constitutes a complaint. The Banking Ombudsman has definitions of 'complaint' and 'dispute', but not all banks use these. This hinders the ability of banks, regulators and the wider industry to form a consistent view of the issues that cause complaints, and how widespread these are. We believe there is an opportunity for organisations such as the Banking Ombudsman and the New Zealand Bankers Association to play a greater role in driving consistency in this area, raising customer awareness of complaint and dispute resolution processes, and using insights from complaints to improve customer outcomes.

In contrast, some banks had systems and processes to capture all customer complaints, regardless of the nature of the complaint or speed of resolution. These banks typically analysed this data to identify emerging trends and address issues. A number of banks are also producing reports for senior management and their various conduct or risk committees, to ensure that complaint trends and responses are well understood across the organisation. For example, one bank has introduced a remediation governance forum to ensure suitable oversight of remediation activity. We are encouraged by banks that are investing time and effort to improve their response to issues requiring remediation.

A number of banks have a significant amount of work to do to remedy problems identified by customers. We expect all banks to have appropriate systems and processes to record and resolve customer complaints. This includes defining what a complaint is, and training staff on how to deal with complaints.

We also expect banks to look beyond customer complaints, and have systems and processes to proactively identify (from a range of sources) issues that may require remediation. Banks need to stop relying solely on lag indicators, and use lead indicators to provide insights and positive assurance about customer outcomes. It is also imperative that banks learn from previous instances of misconduct. Boards should seek positive assurances from management about customer outcomes, and not just rely on the absence of reported issues as a measure of effectiveness of the bank's conduct and culture.

Issues being remediated

We looked at issues that banks had identified and were currently, or had recently finished, remediating. We also identified other issues, including some that banks had not yet remediated. Four banks did not identify any issues requiring remediation. We take little comfort from this, as it likely reflects weaknesses in the systems and processes for identifying and recording issues, lack of effort in identifying issues, or a lack of understanding about how misconduct may arise.

Our review identified more than 50 remediation activities that were in progress or recently completed. Our findings in this area include the following observations:

- For remediation issues where banks had estimated the financial impact, an estimated 431,000 customers had been impacted, at a total estimated remediation cost of $23.9 million. There are a number of remediation activities underway where the impact on customers is yet to be determined.
- The four largest remediation activities underway (in terms of customer numbers) affect a combined total of 336,000 customers, with a total estimated remediation cost of $12.7 million. Each of these issues is estimated to affect between 60,000 and 110,000 customers. The estimated average impact per customer is relatively small (between $5 and $100).
- The majority of issues appear to have been caused by system or process weaknesses, or processing errors. It is concerning how relatively commonplace these problems are.

These system and process issues resulted in a broad range of impacts on customers, including the following:

- Incorrect disclosure of fees or interest.
- Changes to fees not applied consistently to new and existing customers.
- Incorrect interest rates applied to credit cards.
- Fee waivers not applied consistently.
- Loyalty points for credit cards awarded incorrectly or not at all.
- Potentially inappropriate unsolicited offers of credit sent to customers.
- Customers not receiving new credit or debit cards due to the postal address being incomplete in the systems.
- Interest rate changes not implemented correctly.
- Inaccuracies in customer transaction records and statements.

These issues, while occurring across most banks, appear to have a relatively low average financial impact per customer. This could change as banks continue to work through the assessment and remediation of issues.

Key factors contributing to these issues appear to be underinvestment in systems, and reliance on manual processes to compensate for system weaknesses. For example, some banks had not made appropriate system changes when introducing product changes or promotions, meaning staff were required to make manual changes. Manual processes are more difficult to oversee, and are more likely to result in errors and omissions.

We also identified a small number of issues related to poor conduct of bank staff rather than systems or processes. While fewer customers were affected by these issues, the financial impacts to customers and the banks are potentially larger. Based on the information disclosed by banks, these instances of poor conduct were not widespread. However, we are concerned that the small number of conduct issues identified by banks indicates their inability to proactively identify conduct issues or even understand what poor conduct looks like in their business.

These instances of poor conduct included the following examples.

- One bank identified legacy products where the associated fees materially outweighed the benefits to customers. The bank is closing these packages, advising customers and paying refunds where appropriate.
- One bank received complaints about unwanted insurance products. The bank completed an assessment of the usefulness of insurance policies to customers, and is now considering refunds for customers and training requirements for staff.
- One bank discovered that a staff member was excluding relevant information about existing debts from credit applications in order to approve them. The bank has reviewed the staff member's historical lending approvals and is working with customers to determine whether the lending is affordable, or if changes are needed.
- One bank advised us of a recently identified practice within a specific region where staff working at one branch which had met its sales targets were recording their additional sales against the records of another branch in order to help that branch meet its sales targets.
- Staff at one bank manipulated customer records to prevent customers from receiving satisfaction surveys. This happened if it was likely the customer would provide negative feedback, which may have impacted on staff incentive payments.

Banks also identified a number of key conduct risks in their businesses, and in some cases, are instigating deep-dives to identify if there are issues that need to be remediated.

In some banks, there has been a significant amount of time between identifying an issue and concluding the remediation activity. We expect banks to proactively seek to identify issues in a systematic and methodical way, and prioritise remediation.

Any remediation issues that warrant further investigation and potential enforcement action will be considered by the FMA, RBNZ or the Commerce Commission, depending on who is responsible for the legislation relevant to the issue.

Assessment against ARC issues

There is concern that the issues identified in Australia may also be occurring (or have the potential to occur) in New Zealand. New Zealand's four largest banks are owned by Australian banks, and are likely to have commonalities in their internal governance, policies and procedures.

However, a number of banks provided us with reasons why they believe the New Zealand banking environment and culture is different to Australia. These banks assert that the issues in Australia are unlikely to be occurring in New Zealand – or if they are occurring, they are less widespread and are likely to be identified more quickly. Banks in New Zealand cited the following differences:

- New Zealand's banking market is smaller and simpler than Australia's, with fewer and less complex products available to customers.

- Superannuation is compulsory in Australia, and there is a wider variety of more complex superannuation products and structures available.
- Australia's tax structure means different and more complex products are offered there.

While we agree these features are present, we do not accept that the differences between Australia and New Zealand are sufficient to insulate New Zealand banks against all the conduct issues being identified in Australia. We expect all banks to proactively review the work of relevant regulators and related international examples to help identify potential conduct and culture issues here.

All of the large banks, and some small banks, have started work programmes to examine the key themes and issues arising from the ARC, and determine whether there are similar issues present in New Zealand. This work is at an early stage for many banks – some have not yet done any thorough analysis – and may identify more issues that require remediation. We will continue to review their progress as part of our ongoing monitoring of the banking sector.

As part of this review, we sought insights from six external stakeholders that have an interest in the conduct and culture of New Zealand banks:

- FinCap (formerly National Building Financial Capability Charitable Trust – an umbrella body for 198 organisations providing free budgeting and financial mentoring advice in New Zealand)
- Consumer NZ
- New Zealand Bankers' Association
- Banking Ombudsman
- First Union
- E tū (trade union)

Many of the issues they raised are consistent with findings that emerged under our four themes.

The stakeholders had a mix of views on banks' conduct and culture. Some noted banks' positive contribution to the community and initiatives to respond to customer needs. Others told us there are a number of areas where conduct and systems could be improved or where stakeholder expectations are not being met. None of the stakeholders indicated there were widespread conduct issues similar to those highlighted by the ARC.

Issues raised by stakeholders included the affordability of some lending, and unsolicited offers of credit and other products to customers. There was also some concern about whether there are appropriate products and levels of support for customers facing financial difficulties. Some stakeholders who deal with vulnerable customers noted in particular that these people as a group need greater focus from banks (see page 16).

Incentives based on sales targets, which can lead to pressure on bank staff to sell and pressure on customers to purchase, were identified as an issue and source of complaints by some groups. Stakeholders acknowledged recent announcements by some banks to remove sales targets for staff incentives as a positive move.

Some stakeholders mentioned a lack of awareness and access to complaint processes as an area of concern. The capability and capacity of some banks' internal dispute resolution processes was also highlighted as an issue.

Complexity of terms and conditions, and other bank documentation was noted as an area that banks should continue to work on improving.

Our stakeholder feedback also found that banks have recently been more open and active in seeking to identify and address customer and stakeholder concerns.

Gaps in the regulatory environment

New Zealand's two main regulators of financial markets are the FMA and the RBNZ.

The FMA's purpose is to facilitate the development of fair, efficient and transparent financial markets, but it does not regulate all of New Zealand's financial market activities. Its core focus is to regulate the conduct of financial market participants specified under financial markets legislation, such as financial advisers, KiwiSaver providers, retail fund managers, supervisors, issuers of financial products, and licensed market operators.

The FMA regulates the conduct of banks in relation to specific products or services where the bank holds a Financial Markets Conduct Act 2013 (FMC Act) licence or other regulatory authorisation to undertake those activities, which include managing a retail investment fund, issuing derivatives or providing advice through a Qualifying Financial Entity. The FMA also enforces fair-dealing laws as they apply to banks, although these are limited to a prohibition on deceptive or misleading conduct in relation to financial products and services, as defined by the FMC Act[9]. Lending and the provision of consumer credit are excluded from these provisions.

The RBNZ regulates banks, insurers and non-bank deposit takers to maintain a sound and efficient financial system.

The RBNZ's focus on conduct and culture reflects this prudential mandate. It is concerned about the conduct and culture of banks to the extent that undesirable behaviours and attitudes towards risk-taking and risk management can impact the viability of a financial institution, which in turn may impact financial stability. Poor conduct in banks can also lead to significant inefficiency within the financial system or a loss of confidence in our banking system.

In addition, the Commerce Commission is responsible for enforcing the law relating to consumer credit and finance.

> While the current regulatory settings affect our ability to enforce change in governance and management frameworks for conduct risk, the issues identified in this review are not the result of gaps in regulation. The power to make changes rests with the banks, and their desire to change should come from a genuine focus on improving customer outcomes – not the need to comply with the law.

Review and recommendations

We considered whether there are any gaps within the framework for regulation of retail banking services. A regulatory gap may have a number of dimensions. These could include absence or ineffectiveness of:

- licensing requirements
- rules, requirements and standards that the regulated population must adhere to
- enforcement tools that enable regulators to bring about changes in behaviour or provide redress
- the capacity and approach of the regulator.

From a prudential perspective, this review has not identified any notable regulatory gaps for the RBNZ. The RBNZ has sufficient powers, tools and flexibility to investigate and respond to prudential issues related to risk culture, risk governance and risk management.

From the FMA's perspective, the review found gaps in conduct regulation across all four of these areas above. Specific examples include:

- A lack of accountability, and a lack of requirements for systems and controls in relation to the governance and management of conduct risk.
- A lack of requirements in capturing and reporting on misconduct as well as handling customer complaints and undertaking remediation activity.

9. a debt security; equity security; a managed investment product; or a derivative

The review also highlighted weaknesses in the legislative framework for products that are sold without advice, and a lack of a requirement to consider customer outcomes throughout a product lifecycle.

These examples demonstrate the inherent vulnerability in a regulatory system that assigns regulatory coverage to activities and products rather than to entities. Although a consumer may consider that they have a relationship with a bank, New Zealand's regulatory regime (and those of many other countries) determines regulatory coverage based on whether (or how) certain products and services are offered to retail customers. While there are strengths in this approach, such as the ability to tailor rules to particular product and service risks, there is no coherent set of obligations and regulatory influence that applies to all dealings between an entity and its retail customers.

The lack of conduct requirements in the delivery of banking products (particularly those distributed without financial advice) has hampered the FMA's regulatory oversight and the development of consistently strong governance and management of conduct risk across the industry.

The limitations of the FMA's regulatory remit (in relation to general banking conduct) – and more broadly in terms of resourcing constraints at the RBNZ – has made it challenging for us to prioritise bank conduct and culture issues against our more clearly mandated responsibilities. These limitations have likely contributed to the industry's response to conduct risk being slower and less far reaching than we would like. Public interest in the ARC and the generally cooperative response by banks to this review have to some extent masked these gaps, but the underlying weaknesses and their implications remain.

There are a number of ways the government may wish to consider addressing these gaps, to incentivise banks to develop and maintain appropriate management of conduct risk, including:

- Establishing basic legal duties on banks to protect or enhance customer interests and outcomes.
- Requiring banks to have adequate systems and controls to govern, manage and remediate conduct risk.
- Providing regulators with sufficient supervision and enforcement powers and resources to ensure banks meet these obligations, including requiring better information on conduct issues or risks and the option of penalties to incentivise appropriate behaviour.
- Clarifying accountability and individual responsibility for management of conduct, including the potential for direct liability for senior managers.

We appreciate that further policy work will be required to fully explore all options.

In recommending that the Government consider the options noted above, we are also mindful of the number of reviews currently underway in relation to financial services regulation. These include the Financial Services Legislation Amendment Bill, the Reserve Bank Act review, the review of insurance contract law and conduct regulation, and the review of consumer credit legislation.

Appendix: Background to the review

Globally, and in particular following the global financial crisis, there have been significant concerns about weaknesses in banks' governance and risk management frameworks – and more broadly, inappropriate behaviour in the industry that has led to poor customer outcomes.

The Australian Royal Commission was established in December 2017. This was in response to misconduct incidents by financial services entities, as well as conduct seen to fall short of community standards and expectations. When the ARC was initiated, as many as 70 public Australian inquiries concerning the conduct of banks and their associated entities were being carried out or had been completed.

The ARC's interim report, released in September 2018, identifies and examines four broad areas of misconduct – almost all of which contravened existing conduct norms, with the most serious conduct breaching the law. This included:

- taking a customer's money when not entitled to take it (eg charging a fee for service when no service was given)
- preferring personal financial interest over the customer's interest when obliged to act in the customer's best interests (eg remunerating employees in a way that emphasises sales)
- misleading or deceiving the customer (eg misleading or deceptive conduct by financial advisers in relation to clients)
- breaking some specific requirement of the law (eg consumer lending provisions).

Evidence from the first four rounds of the ARC hearings also points towards entities treating regulatory compliance as a cost of doing business, rather than it informing and underpinning how the business must operate.

The interim report, in accordance with the ARC's terms of reference, also discusses the effectiveness and ability of regulators to identify and address misconduct.

The FMA and RBNZ are concerned about the impact that the evidence of widespread misconduct in Australia could have on confidence in New Zealand's financial institutions, especially given the four largest banks in New Zealand are Australian-owned. Equally, we are concerned about the risk of complacency in the industry with respect to culture and conduct issues. The level of public concern in Australia has raised public questions and speculation about whether there are similar issues in New Zealand.

Risks to customers

A customer is a person who buys financial products and services, including investment products. Banks need to be aware of, and responsive to, their customers and their customers' financial capability, and tailor their interactions with the customer accordingly.

Customers also have a responsibility to act in their own interest and make good decisions. However, our view is that banks should think about how their conduct supports customers, including by providing them with the necessary information and understanding so they can exercise that responsibility properly. All customers, regardless of their level of knowledge, are entitled to expect good conduct from their bank.

Delivering financial services comes with challenges and risks, particularly due to information asymmetry and conflicts of interest. This is particularly true in banking, where banks typically hold a lot more information about their products, and customers are reliant on the bank providing information so that they understand the products.

Conflicts of interest can arise from how staff are incentivised. If staff are incentivised to prioritise selling certain products or reaching targets over addressing customers' needs, they may recommend or sell a product that is not suitable.

It is difficult for customers and banks to know at the point of sale if a product will be suitable in the longer term. Additionally, any harm caused by poor product design or inappropriate sales or advice may not become apparent until years later, if at all. Some financial decisions made by customers are life-changing, and misconduct by banks can have a significant impact on customers.

When a bank does not demonstrate good conduct and culture, its customers face a range of risks, including the following:

- The bank prioritises its own interests over those of the customer.
- The customer is not treated with professional standards of care.
- The cost of the bank's product or service is not reasonable, and may reduce the return or benefit customers get from it, to the point where the customer's needs are not met.
- The purpose, benefits and risks of services and products, and their suitability to different types of customers, are not clear to customers.
- Customers do not understand how staff performance incentives, or any arrangement with related parties, impact the product or service offered from their bank, and make poor financial choices as a result.
- Customer feedback and complaints are not dealt with appropriately, resulting in adverse consequences for customers.

Scope of the review

The overall objective of this review was to understand whether there are widespread conduct and culture issues present in banks in New Zealand. We obtained information from 11 banks to seek answers to the following questions:

- What conduct and culture issues and risks are present in New Zealand banks?
- What governance, frameworks, processes and controls are in place to achieve good conduct and culture, and to effectively manage and remediate any conduct and culture issues or risks?
- Are there areas within the framework for regulation of retail financial services where we consider there are regulatory or supervisory gaps or inefficiencies? What are our recommendations to deal with these gaps or inefficiencies?

Our review focused on the retail banking activities of 11 banks, which by size account for 99% of resident household deposits in the New Zealand banking system. Any non-retail banking activities were outside the scope of this review. For example, we did not review conduct and culture within the institutional and corporate banking divisions of each of the banks, as these mainly provide banking services to very large companies.

The structure of some banks means subsidiaries, or other companies in their group, are involved in providing the bank's products and services. For example, some banks sell insurance products provided by an insurance company that is owned by the bank or a related party. In this instance, our review considered the conduct of the bank when selling these products and services, but not the conduct and culture of the subsidiary or related company. We are undertaking a separate thematic review of conduct and culture of life insurers, and are planning to publish a report when the review is complete.

One of the factors that contributes to good conduct is the effective management of conflicts of interest. We expect banks to clearly identify, manage and disclose their actual and potential conflicts, particularly how staff are incentivised. Our review looked at the incentives that banks are providing to staff, and how they manage conflicts arising from these incentives. However, incentives were not a significant focus of this review.

The FMA has conducted a separate thematic review into bank incentive structures, which will be published in November 2018. The purpose of that review was to understand how banks design and manage the incentives they use for sales staff. Some of the insights from the FMA's review of bank incentives are included in this report.

Limitations of our review

We undertook the review over a four-month period using existing resources of the RBNZ and FMA. Within this timeframe we could not undertake an audit or detailed investigation of each bank, and did not review individual transactions, accounts, credit decisions or product sales.

Our review was limited to the documents and information we collected directly from the banks, and from interviews with bank staff and directors. While we did not seek information directly from customers, where appropriate, we did consider information that customers had provided to the FMA and RBNZ, such as enquiries or complaints about their bank.

The thematic findings in this review are the joint views of FMA and RBNZ. While a critical fact check was undertaken with each bank, the findings were not discussed with the banks and stakeholders prior to the completion of this report.

Banks

The target population for this review was New Zealand registered banks with major retail operations. Banks with wholesale operations only, and banks with small retail operations were excluded. This meant we were focusing on the segment of the market that poses the greatest risk of harm to retail customers as a result of misconduct or poor conduct. Our review involved the banks detailed in the table below.

Bank	Market share[10]	Ultimate parent	Country of parent
ANZ Bank New Zealand Limited	32.5%	Australia and New Zealand Banking Group Limited	Australia
ASB Bank Limited	20.4%	Commonwealth Bank of Australia	Australia
Westpac New Zealand Limited	15.0%	Westpac Banking Corporation	Australia
Bank of New Zealand	14.8%	National Australia Bank	Australia
Kiwibank Limited	7.2%	Kiwi Group Holdings Limited	New Zealand
TSB Bank Limited	3.6%	TSB Community Trust	New Zealand
Southland Building Society	1.7%	Southland Building Society	New Zealand
Rabobank New Zealand Limited	1.6%	Coöperatieve Rabobank U.A.	Netherlands
Heartland Bank Limited	1.3%	Heartland New Zealand Limited	New Zealand
The Co-operative Bank Limited	1.3%	The Co-operative Bank Limited	New Zealand
The Hongkong and Shanghai Banking Corporation Limited	0.5%	HSBC Holdings PLC	United Kingdom

10. Market share is measured by each bank's resident household deposits as a proportion of the total resident household deposits in New Zealand, as at 31 August 2018.

Methodology

We collected information for this review by assessing documents provided by the banks, interviewing bank staff and directors, conducting a consumer survey and gathering intelligence from six external stakeholders.

Our review commenced on 30 April 2018, when the RBNZ Governor and the FMA Chief Executive met with 16 CEOs of New Zealand banks. The purpose of the meeting was to seek assurance that the issues identified by the ARC were not evident in New Zealand.

Following this meeting, the RBNZ and the FMA, with the support of the Commerce Commission, wrote to ten locally registered banks with major retail operations. The letter, sent to banks on 3 May 2018, was published and widely reported on. The letter stated:

"Our objective in this exercise is to understand what work you have undertaken to review your operations to promptly identify and address any conduct and culture issues. We expect you to show us what you have done in order to be comfortable that there are no material conduct issues within your business … the purpose of this exercise is to understand how you as leaders of your businesses have obtained assurance that misconduct of the type highlighted in Australia is not taking place here."

We received responses from all ten banks. One additional bank, which was not a recipient of the letter, responded voluntarily. The responses were analysed by the RBNZ and FMA, with initial findings presented to the Finance and Expenditure Select Committee[11] in May 2018.

We undertook further monitoring activity with the 11 banks to validate the information provided in response to the letter, and to understand whether there are widespread conduct and culture issues present in New Zealand. In this phase of our work we received over 1,000 documents from the banks, and interviewed 572 staff, including frontline staff, management and senior executives, and directors within the banks. We visited head offices, contact centres and branches, and interviewed:

- directors
- senior management
- risk and compliance staff
- credit managers
- customer care and remediation officers
- internal auditors
- product design and distribution teams
- human resources staff
- marketing staff
- information technology specialists
- regional and branch managers
- frontline staff.

Our methodology for the interviews included providing the opportunity for bank staff to speak freely and in confidence with us about any issues related to bank conduct and culture. Staff were advised that the information they provided to us would not be associated with them personally in our reporting or in our ongoing work with their bank. Six of the 11 banks

11. A parliamentary committee that focuses on economic and financial matters, including banking and finance, superannuation, and insurance.

had a ‘bank representative’ (such as a staff member from their Regulatory Affairs team) present in the interviews with bank staff. When this was the case, we also provided the opportunity for staff to speak to us without the bank representative being present. Bank staff were advised that what was discussed was in confidence and did not need to be disclosed to their employer.

We assessed whether the conduct demonstrated by the banks met our expectations and would be likely to contribute to good outcomes for customers. During the course of our document reviews and meetings, we evaluated the information provided to us from a variety of perspectives and against different models of good conduct, including the key factors outlined in the FMA Conduct Guide.

Additionally, we conducted a survey[12] of New Zealanders to understand their experience of conduct and culture in their bank. The findings of this survey are included in this report, where relevant.

We also obtained information from six external stakeholders that have an interest in the conduct and culture of New Zealand banks, including consumer advocacy groups, a dispute resolution scheme[13], workers’ unions and an industry association. The insights from these groups are included in this report where relevant.

Overall, we found the bank staff and directors, the external stakeholder groups involved in this review to be constructive and cooperative. We appreciate their assistance in carrying out this review.

12. We used an external agency to conduct a survey of 2,011 New Zealanders aged 18 and over. The survey asked about the quality of interactions and communications that New Zealanders have with their bank, their awareness and experience of bank’s complaint processes, and the level of trust that they have with their own bank and the banking industry as a whole.
13. All financial service providers who provide financial services to retail clients are required to be a member of an approved dispute resolution scheme. Financial Service Providers (Registration and Dispute Resolution) Act 2008, s48.

FMA

FINANCIAL MARKETS AUTHORITY

TE MANA TATAI HOKOHOKO - NEW ZEALAND

RESERVE BANK

OF NEW ZEALAND

TE PŪTEA MATUA