NEW ZEALAND
BANKERS ASSOCIATION

Submission

to the

Financial Markets Authority

on the

Derivatives Issuer Standard Condition on Suitability Consultation Paper

1 October 2014

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Submission by the New Zealand Bankers' Association to the Financial Markets Authority on the Derivatives Issuer Standard Condition on Suitability

About NZBA

1. NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks. NZBA develops and promotes policy outcomes which contribute to a strong and stable banking system that benefits New Zealanders and the New Zealand economy.

2. The following fourteen registered banks in New Zealand are members of NZBA:
   - ANZ Bank New Zealand Limited
   - ASB Bank Limited
   - Bank of New Zealand
   - Bank of Tokyo-Mitsubishi, UFJ
   - Citibank, N.A.
   - The Co-operative Bank Limited
   - Heartland Bank Limited
   - The Hongkong and Shanghai Banking Corporation Limited
   - JPMorgan Chase Bank, N.A.
   - Kiwibank Limited
   - Rabobank New Zealand Limited
   - SBS Bank
   - TSB Bank Limited
   - Westpac New Zealand Limited.

Background

3. NZBA is grateful for the opportunity to submit on consultation paper in relation to the derivatives issuer standard condition on suitability (the Suitability Condition) made under the Financial Markets Conduct Act 2013 (the Act).

4. The process around the development of the Act has been a good example of policy development that has actively involved the industry. NZBA commends the ongoing commitment to meaningful consultation and engagement and appreciates the invitation to participate in this consultation.

5. The following submission makes some brief comments on the Suitability Condition.

6. If you would like to discuss any aspect of the submission further, please contact:

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Delineation between Existing Regimes

7. The suitability assessment condition as proposed in the consultation document creates confusion between the assessment of suitability of advice covered by the Financial Advisers Act 2008 (FAA). There should therefore be greater delineation drawn between the two regimes.

8. Notwithstanding that most of the registered banks' customers would be given advice before entering into a derivative, the FAA allows for 'execution only' business and registered banks do have a number of customers that approach them to execute that business without first being given financial advice. The requirements of this proposed Suitability Condition impacts the ability to efficiently conduct this business.

9. NZBA considers the condition could be improved in the following ways:

Re-labelling the condition to be clearly distinct from the FAA suitability regime

10. We note that the Suitability Condition appears to be based on the United Kingdom Financial Conduct Authority (FCA) 'Appropriateness' test which only applies to non-advised services, and sits alongside the 'Suitability' test which is applied to advisory services. In our view, this 'Appropriateness' test should also only apply in the absence of personalised advice in New Zealand.

Focus the test on ability to understand and expand the relevant factors

11. The FCA assessment of appropriateness sets out a range of factors that an issuer may use to make an assessment, including types of investments the customer has made previously, their level of knowledge of markets and the risks involved in derivatives products. Another inquiry could relate to whether the investor has a genuine objective need for the product. We consider that these factors, and others that are covered in the guidance relating to the appropriateness test, focus the inquiry on whether a retail investor has the ability to understand the particular product and the associated risks. This approach appropriately requires issuers to take into consideration factors such as an investor's relevant background, experience and employment, access to specialist advice, such as accountants, financial planners, financial risk management, legal and also take account of any information received during the course of discussions with the investor.

12. The benefit of an appropriateness test, as proposed, is that it does not close the market to new investors who will not have experience or pre-existing knowledge, provided they have the capability to understand the product and can make an informed decision about the product.

13. These factors could be set out in the explanatory note to the Suitability Condition, and would ensure the policy objective has been met, particularly by broadening the issuer's inquiry.

14. NZBA and its member banks would like to meet with FMA to discuss what type of factors would be relevant to an assessment under such a test. We will be in touch to arrange a mutually convenient time.

Flexibility under Current Approach

15. If the Suitability Condition is to remain, then NZBA submits that the Suitability Condition should not form part of the derivatives issuer standard conditions that apply to all derivatives issuers. This is because banks are responsible derivatives issuers and have comprehensive processes in place to ensure that customers understand the nature of the products they are entering into. However, these processes may not align with the requirements of the Suitability Condition as drafted. These processes are designed to achieve the same policy outcome as the Suitability Condition, and we submit that there is little benefit in requiring new systems to be set up to achieve the same end. We suggest instead that this could be dealt with in a special condition, imposed where appropriate, that is drafted in such a way so as to provide flexibility in demonstrating compliance. This could be achieved through the licensing process by giving a licensee the opportunity to either elect to comply with the Suitability Condition in the form confirmed by the FMA, or to demonstrate some pre-existing process (such as an assessment in the client on-boarding process) that provides comfort that the product in question is appropriate for the client.

16. As currently drafted, there will be difficulties associated with assessing suitability for customers who are not individuals, such as corporates, partnerships or trusts. For example, do you assess the level of understanding knowledge and experience of the representative authorised to enter into the derivative on behalf of the customer, or one or more of the directors, partners or trustees? The approach suggested in paragraph 11 above would help to address these difficulties.

Existing Customers

17. We submit that if the knowledge and experience assessment is adopted, further explanation will be required as to the treatment of existing customers. In particular, we do not anticipate that derivatives issuers will be required to go back and assess the suitability of products for existing customers. Such an approach could have serious ramifications.

18. We note that the FCA equivalent in the UK contains a grandfathering provision which presumes a sufficient level of knowledge for existing customers. We submit that a similar approach would be appropriate in the New Zealand context. However, we note that this is a presumption of understanding only, which would not withstand any reason to believe on an issuer's part that an existing customer does not have the requisite level of understanding. Existing customers would also be subject to the ongoing assurance processes which would assess whether the appropriateness factors remained relevant.

Drafting points

19. Some drafting in the proposed Suitability Condition is unclear. For example, the condition requires issuers to ask customers to provide information and anticipates that it may not be provided, but then suggests that issuers are 'required' to obtain information.

20. The consequences of the 'you may consider' wording in the last paragraph of the proposed Suitability Condition are unclear. One possible interpretation is that if the issuer does enter into the derivative then that decision could be challenged on the basis that the issuer did not properly have regard to all the circumstances, but this is not clearly spelled out. A clearer statement would be preferable, e.g. "If a retail investor asks you to go ahead with entering into a derivative, despite being given a warning, then you may do so."

Scope

21. We note that clause 210(1)(g) of the draft Financial Markets Conduct Regulations 2014 gives FMA the power to impose a condition that requires a licensee to have systems or procedures for preventing the issue of a derivative to a retail investor where the derivative is assessed as not suitable. The condition as currently drafted appears to allow a transaction to proceed as long as a warning is first given, even if the issuer has reached the view that the investor does not have the requisite knowledge and experience. Banks are unlikely to rely on the warning mechanism as they would not generally enter into transactions with customers who are not able to understand the derivative, but NZBA is concerned that the warning could be used by less scrupulous derivatives issuers as implied regulatory permission to enter into such transactions (particularly in light of FMA's power to impose a more limiting condition). The warning mechanism may be more appropriate where an investor refuses to provide information relevant to the assessment of their knowledge and experience (as in such a scenario the investor is effectively accepting the risk of not being assessed) but where an assessment indicates that the investor does not understand the transaction or its risks, we consider FMA should use its power to ensure the condition prevents the issue of a derivative to the retail investor at that time.