

Financial Markets Authority Efficiency, effectiveness and baseline review

Final report

December 2019



Contents

Executive Summary	4
Review purpose and scope	4
Efficiency and effectiveness	4
Baseline options	6
Overall conclusion – baseline options	8
Introduction	9
Review purpose and scope	9
Review methodology	9
Report structure	10
Background	11
The regulatory environment	11
Who the FMA regulates	14
FMA’s strategic priorities	15
Government expectations	16
Part A: Efficiency and effectiveness	17
Introduction	18
Is the FMA focused on the right thing?	18
Are resources being used effectively and efficiently?	25
Opportunities for improving efficiency and effectiveness	32
Part B: Baseline options	36
Introduction	37
Background – financial situations and resources	37
Option 1: No funding	41
Option 2: Current spend	44
Option 3: Base	52
Option 4: Enhanced	62
Baseline summary and conclusions	69
Appendix A: Restrictions	72
Appendix B: List of Interviewees	73
Appendix C: Summary of funding needed for the baseline options	74



Private and confidential

Sharon Corbett
Manager, Financial Markets Policy
Commerce, Consumers & Communications Branch
Ministry of Business, Innovation and Employment
PO Box 3705
WELLINGTON 6140

18 December 2019

Financial Markets Authority Efficiency, Effectiveness and Baseline Review

Dear Sharon

We are pleased to attach our final report regarding the efficiency, effectiveness and baseline review of the Financial Markets Authority (FMA). This incorporates feedback, as appropriate, received in relation to the draft final report that we provided to you on 13 December.

This final report is provided in accordance with the terms of reference of our engagement as set out in our Consultancy Services Order dated 29 August 2019 and is subject to the restrictions set out in Appendix A.

Please note that this report is also being copied to the FMA.

We'd like to thank the Ministry and the FMA for your assistance with the review. It has been a pleasure working with you.

Yours sincerely

Chris Gould
Director

Richard Forgan
Partner

Executive Summary

Review purpose and scope

The Financial Markets Authority (FMA) is an independent Crown entity. Its primary statutory objective is to promote, and facilitate the development of, fair, efficient and transparent financial markets.

Since its establishment in 2011, the nature and scope of the FMA's roles and responsibilities have changed significantly and the FMA is now experiencing cost pressures. Further changes in the FMA's remit are expected which will exacerbate these pressures. As well as demand pressures, there is also now greater attention on regulatory agencies across the board with a focus on lifting their general performance to mitigate the risk of regulatory failure occurring and the harmful effects of such failure. In light of these points, it is timely to consider the cumulative impact of the demands being placed on the FMA and the implications for funding.

It is desirable for the FMA to be a credible conduct regulator that is sufficiently resourced, resilient and able to adopt a proactive, risk-based and systems-wide approach to regulation that includes contributing to wider government policy objectives, where appropriate.

Reflecting this, the scope of this Review has two main parts. The first of these is an assessment of the efficiency and effectiveness of the FMA. The purposes of this part of the Review are to provide assurance regarding the extent to which the FMA is focused on the right activities in support of its main statutory objectives and the extent to which resources are efficiently and effectively directed to these ends. This part of the Review is also aimed at identifying opportunities for improving organisational performance.

The second part of the Review focuses on right-sizing the FMA. To this end, the scope involves development and assessment of four baseline options with a view to identifying the option that best supports the efficient and effective discharge of the FMA's remit.

An important limitation to the Review's scope concerns the FMA's new remit under the new conduct regime for banks, insurers and non-bank deposit takers. This new remit, as announced by the Government on 26 September 2019, is not within the scope of this Review. Notwithstanding this, some limited resource that is focused on initial preparation for the implementation of the new conduct remit, has been included in one of the baseline options (the enhanced option).

This Review has been commissioned by the Ministry of Business, Innovation and Employment (MBIE or the Ministry) which is the government department responsible for monitoring the FMA.

Efficiency and effectiveness

For the reasons set out below, we consider that the FMA is a high-performing organisation.

There is good alignment between the activities performed by the FMA and its main statutory objective. The FMA has a robust and risk-based process for determining its strategic priorities and these priorities provide good support for the achievement of the statutory objective and associated outcomes.

The FMA is funded by a multi-category appropriation. The allocation of resources across the three main elements of the appropriation is balanced although we consider that there is scope to allocate more resource to investigation and enforcement as the regulatory regime matures.

Overall there are many indicators that point to resources being used effectively. Effectiveness in this sense refers to the impact that comes from the FMA's work. The headline metric in this regard is the percentage of investors who are confident in NZ's financial markets. Averaged over the last three years, 67% of investors have expressed confidence. This is a higher proportion than in the years following FMA's establishment (2011) and reflects the impact of conduct-based regulation taking hold.

The FMA is widely viewed as raising standards of market conduct and supporting market integrity as evidenced by survey-based information. The FMA has a suite of 14 impact measures that are regularly reported in its accountability documents. Performance across all of these measures is strong.

The FMA is one of quite a few agencies that have a role to play in the regulation of financial markets. Others include the Reserve Bank of New Zealand (RBNZ) the Commerce Commission, Serious Fraud Office, MBIE, the Treasury, NZ Police and others as well. There is also a range of inter-agency bodies both domestically and internationally, that have roles to play. The FMA has established and maintains relationships with these agencies and bodies, and surveys confirm that these relationships are effective.

In terms of efficiency, there is a similar finding of strong performance. The FMA reports against several efficiency-oriented measures and, for the most part, has consistently met or exceeded target levels of performance. In short, and as commented to us by several external interviewees, the FMA “punches above its weight” both in terms of the level of activity and the impact stemming from that activity.

Notwithstanding our findings regarding efficiency and effectiveness, we have identified some areas for ongoing improvement.

- The FMA’s strategic priorities have a dominant focus on conduct and promoting trust and confidence in markets. However, the development (including growth) of financial markets is not explicitly addressed. It is important not to lose sight of this aspect of the FMA’s statutory objective.
- There is good line of sight between organisational plans and strategic priorities. However, business plans lack financial and resource information. There are also opportunities to strengthen the approach to monitoring and assessing the use of resources within the organisation.
- Over the last 18-24 months, the FMA has made significant investment in technology which was an area of previous under-investment. Opportunities for further investment remain, however, and these offer the prospect of improving organisational efficiency including through being able to better track, report on and manage the utilisation of resources and to streamline and automate business processes.
- Investment in technology (data analytics) coupled with a strengthening of the FMA’s intelligence function would also pay dividends in terms of better understanding where risks lie and the tailoring of regulatory response.

A problem facing the FMA, however, is the fact that financial resources are constrained and there are multiple pressure points within the organisation. As a result, the FMA does not have sufficient financial headroom or organisational capacity to address the opportunities for improving efficiency and effectiveness including those summarised above. In short, we do not consider that the organisation is currently right-sized. Other funding options need to be considered as discussed below.

Baseline Options

Four baseline funding options have been developed and considered. An overview of the options, and an assessment of each is provided below.

Option 1 involves no change in the existing baseline funding of \$36m. The salient feature of this option is cuts to expenditure in order to address existing and forecast financial deficits.

The other three options involve progressively greater amounts of expenditure and, hence, funding. Most of this is operating funding with a small amount of capital funding.

It is important to note that when referring to the amount of additional funding required, we have taken into account the modest amount of revenue received by the FMA over and above the appropriation.¹ Other sources of revenue, apart from the appropriation, include audit quality review fees, licence fees, superannuation fees and sundry revenue. In FY19², other revenue summed to \$0.721 million. It should also be noted that we have expressed the amount of funding needed on a year-by-year basis rather than expressing the amount needed as an annual average.

¹ In the FMA’s financial statements, the appropriation is referred to as the Government grant.

² Throughout this report, FYXX means the financial year ending 30 June XX.

The amounts of funding needed for Options 2, 3 and 4 are summarised below.

Operating funding \$m	FY21	FY22	FY23	FY24
Additional funding needed for Option 2	7.673	8.073	10.020	11.098
Incremental funding for Option 3	5.805	10.308	10.242	10.503
Total additional funding needed for Option 3	13.478	18.381	20.262	21.601
Incremental funding for Option 4	1.686	4.693	4.742	4.739
Total additional funding needed for Option 4	15.164	23.074	25.004	26.340

Capital funding \$m	FY21	FY22	FY23	FY24
Funding for Option 2	3.300	-	-	-
Incremental funding for Option 3	-	-	-	-
Total additional funding needed for Option 3	3.300	-	-	-
Incremental funding for Option 4	0.500	-	-	-
Total additional funding needed for Option 4	3.800	-	-	-

Option 1: No more funding

Option 1 is not viable and does not warrant further consideration. It maintains the appropriation at its current level of \$36.000 million. This option would necessitate a reduction in expenditure because the FMA is already spending more than this and, reflecting demand and cost pressures, expenditure on current plan is forecast to increase further.

Under Option 1, a substantial headcount reduction, and consequential cut in operating expenditure would be required to close the FMA's operating deficit (forecast to be \$4.245 million in FY20) and enable deployment of resources to execute the FMA's new regulatory functions in relation to the new financial advice (FA) regime and follow up to the Conduct and Culture (C&C) reviews.

The cut in operating expenditure is likely to have a substantial and adverse impact across all of the FMA's outputs: monitoring and supervision, investigation and enforcement, market analysis and guidance, investor awareness and regulatory engagement. This retraction is likely to have a detrimental effect on market confidence and the reputation of the New Zealand financial markets.

Option 2: Current spend

Option 2 (current spend) is not a desirable option. In FY21, the additional funding for Option 2 is \$7.673 million growing to an increase of \$11.098 million by FY24. Under Option 2, operating expenditure in FY21 is \$44.601 million increasing to \$47.846 million in FY24.

Option 2:

- has a medium level of strategic fit with the Government's expectations and the FMA's strategic priorities
- provides a bare minimum to enable the FMA to implement and administer the new FA regime, but monitoring activity would be primarily reactive with proactive monitoring directed to the highest risks only

- allows for only tactical follow-up on the conduct and culture reviews of banks and life insurers
- does not have good strategic alignment with the expectation that the FMA will shift toward an increased customer protection focus, on top of its existing investor focus
- does not provide sufficient resource to deal with all pressure points which means some areas of deferred activity may continue to be under-resourced (thematic reviews are a likely example) and other areas of pressure, if addressed, will be replaced by new issues for which there is insufficient resource
- does not allow for increased investigation and enforcement activity (which, as noted in Part A of the report, is an activity that warrants increased activity)
- does not address concerns regarding the need for building capability and resilience and so does not future-proof the FMA
- increases the risk of regulatory failure from the current level because resources are stretched thinly and pressure points are not adequately addressed
- does not optimise value for money (ie benefits relative to costs) as more can be done that delivers significant benefits over and above the costs involved.

Option 2 is a minimal approach to financial regulation, especially given the growth in remit and expectations and constrained capacity. The main effect is a greater focus on prioritising activities, limiting these to pursuing the FMA's core mandated activities and being reactive rather than proactive. Resources are stretched thinly over a broader remit which means that in some areas regulatory attention will fall below expectations. For example, there will be insufficient additional support for the large number of people who have investments (eg in KiwiSaver) but who are not financially literate and do not consider themselves to be investors. The impact will be to increase risk and harm, particularly in those industries that are newly regulated and for non-expert investors.

In general, this option represents a slower and riskier approach to achieving fair, efficient and transparent markets than Options 3 and 4. It does not provide the capability or capacity for the FMA to effectively address the regulator's current view of the level of conduct risk in financial markets, driven by the relatively low levels of conduct maturity across large areas of the market. As with the no-funding option, this is likely to lead to a build-up of system risks, the types of which were highlighted by the Australian Royal Commission.

Option 3: Base

Option 3 is a good option but is not optimal. Total expenditure is \$50.406 million in FY21, growing to \$58.348 million in FY24. In order to achieve break-even in a financial sense, additional annual operating funding of up to \$21.601 million (by FY24) is needed.

This option enables the FMA to be a more effective regulator than is possible under Option 2. It enables a more effective and better resourced inter-play between FMA's regulatory levers and roles; the effectiveness of the regulator rests, in part, on a well-rounded approach.

Option 3 aligns with the FMA's strategic priorities and goes some way to meeting Government's expectations.

- The level of resource assigned to the new FA regime will enable the FMA to adopt a risk-based, and relatively swift, approach to implementing the regime.
- Some additional resource is directed for follow-up to the recent conduct and culture reviews, although this would be a mostly tactical, rather than strategic, approach (and recalling that if the FMA is expected to play an ongoing role in regulating the conduct of banks and insurers, it will need to have sufficient funding – something that is outside the scope of this Review).
- Option 3 enables more investigation and enforcement activity, in line with a maturing regulatory regime that is dealing with those who persistently fail to comply with their regulatory obligations.
- Resource is directed to strengthening the intelligence function. This is highly desirable because it helps with understanding where risks and harms are greatest and ensuring an appropriate regulatory response.
- The additional resource enables the FMA to adopt a more portfolio-based approach to supervision, as well as more thematic reviews and intensive work with businesses that are viewed as being high risk.
- Option 3 includes some resource to address a range of issues that have been on the back burner because of the C&C reviews and some surge capacity for better organisational resilience.

The above features of Option 3 contribute to the ability to identify and deal with risks and harms sooner than would be the case with Option 2. Investors and customers should, therefore, have more confidence in markets and be at less risk of harm under this option.

Overall, and reflecting the points above, we consider that Option 3 is likely to deliver strong value for money (acknowledging the challenges in trying to quantify in monetary terms the outcomes of regulation) and more value than is true of Option 2. However, this option does not provide much scope for future proofing the FMA for likely upcoming changes to markets or increases in expectations and, moreover, as discussed below, Option 4 has the potential to deliver even greater value for money.

Option 4: Enhanced

Option 4 (enhanced) is our preferred option because it delivers even more benefit than Option 3. Total expenditure is \$52.092 million in FY21, growing to \$63.088 million in FY24. To achieve financial breakeven, Option 4 involves additional annual operating funding of up to \$26.340 million by FY24.

In addition to the benefits associated with Option 3, Option 4 offers some distinct advantages over and above any of the other options. In particular, Option 4:

- enables a shift to a much stronger systems focus in its work including supporting greater financial market system coordination and engagement
- enables a shift to a greater focus on customers over and above the existing focus on investors including more work on good customer outcomes, and employing innovative approaches such as behavioural economics to enhance conduct outcomes
- enables more focus on providing conduct guidance to market, thereby reducing regulatory burden
- enables deeper and faster progress to be made with understanding the FA market, the risks posed and how to address those risks
- provides the FMA with some additional resource in relation to conduct and culture thereby allowing the FMA to begin (but not execute) the process of planning and preparing for its new conduct and culture remit, maintain a higher level of momentum regarding the follow-up to the C&C reviews, and take both strategic and tactical approaches to the follow-up
- supports a significant focus on capability and building the FMA's maturity as a regulator, most notably in focusing on building expertise in areas such as thematic work, and sector and business model expertise
- provides greater capacity and ability to utilise and realise the benefits of the new technology and IT systems that, to date, has not been possible because of resource constraints.

Although Option 4 involves additional funding of up to circa \$5 million over and above Option 3, this is more than outweighed by the additional benefits that are delivered by Option 4. Because of the additional features that Option 4 brings, we consider it is the preferred option.

Overall conclusion – baseline options

Based on the assessment described above, we recommend Option 4 as the preferred option.

Introduction

The Financial Markets Authority (FMA) is an independent Crown entity under Schedule 1 of the Crown Entities Act. Its primary statutory objective is to promote, and facilitate the development of, fair, efficient and transparent financial markets.

Since its establishment in 2011, the nature and scope of the FMA's roles and responsibilities have changed significantly and further changes in its remit are expected. In light of this, it is timely to consider the cumulative impact of the demands being placed on the FMA and the implications for its funding.

This Review has been commissioned by the Ministry of Business, Innovation and Employment (MBIE or the Ministry) which is the government department responsible for monitoring the FMA.

Review purpose and scope

The purposes of the Review are primarily threefold. These are to:

- provide assurance regarding the efficiency and effectiveness of the FMA (ie is the FMA focused on the right activities in support of its primary statutory objective and are resources being used effectively and efficiently?)
- identify any opportunities for lifting the FMA's performance
- identify the right size for the FMA (ie identify an appropriate level of funding that will enable the FMA to execute both its current and anticipated functions in the manner, and to the extent required by, Government).

All aspects of the FMA's current roles and responsibilities are within the scope of the Review.

Excluded from terms of reference

The FMA's new remit under the new conduct regime for banks, insurers and non-bank deposit takers, as reflected in legislation introduced 11 December 2019 (the new conduct remit), is not within the scope of the Review. Notwithstanding this, some limited resource focused on initial preparation for the implementation of the new conduct remit has been included in one of the baseline options (the enhanced option). The FMA will need to be sufficiently resourced for the new conduct regime.

Out of scope for the Review is an evaluation of whether relevant law reforms in past years have lifted the overall wellbeing of New Zealanders or to review the governance model of the FMA. Detailed international benchmarking and analysis against international regulators has not been required.

Review methodology

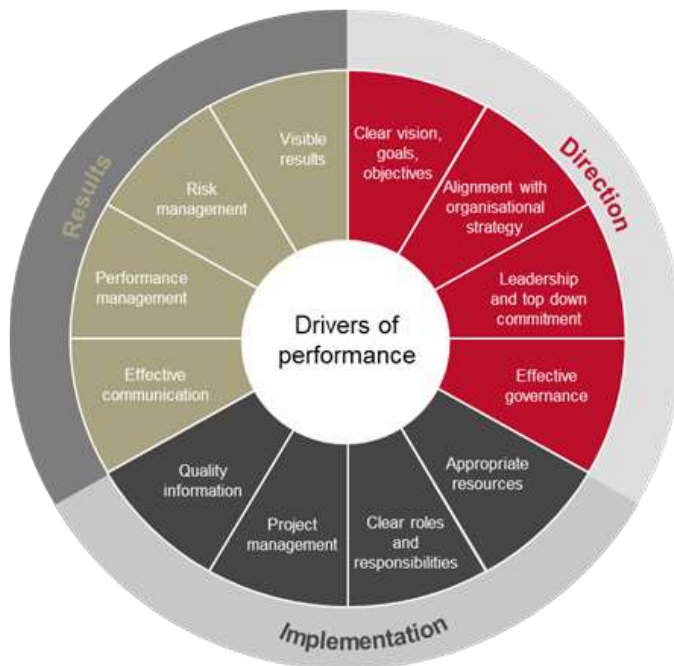
The methodology we use provides a structured approach to assessing efficiency and effectiveness.³ We have applied it to deliver a clear view of:

- how well activities are aligned with the FMA's strategic priorities and the Government's expectations of the FMA (ie is the FMA focused on the right things?)
- how well the FMA is performing (the efficiency with which resources are used and the quality of outputs delivered)
- the extent to which the FMA has the appropriate mix and level of resources to efficiently and effectively undertake its roles.

³ It is underpinned by an internationally recognised methodology - Leclerc, G., W.D. Moynagh, J.P. Boisclair and H.R. Hanson (1996) "Accountability, Performance Reporting, Comprehensive Audit - An Integrated Perspective" Ottawa, CCAF. (Canadian Comprehensive Audit Foundation).

The methodology addresses all dimensions of what drives performance (as illustrated below) and, in so doing, identifies what is working well and where there are opportunities for improvement.

Figure 1: Drivers of organisational performance



This Review was informed by extensive documentation review and stakeholder engagement including interviews with FMA and Ministry personnel as well as a range of external stakeholder organisations (as listed in Appendix B).

Report structure

Beyond this introductory section, this report is divided into two main parts.

Part A focuses on efficiency and effectiveness. We begin by providing an overview of the regulatory environment within which the FMA operates. This is followed by an assessment of the extent to which:

- the FMA has focused its activities on the right things
- resources are being used effectively and efficiently
- there are opportunities for improving efficiency and effectiveness.

Part B turns to the issue of the appropriate level of funding for the FMA. Four baseline funding options are described and assessed. A preferred option is identified.

Background

The regulatory environment

The FMA enforces the Financial Markets Conduct Act 2013 (FMC Act) and certain securities, financial reporting and company laws as they apply to financial services and securities markets. When established in 2011, the FMA assumed the regulatory functions of the former Securities Commission, the Government Actuary and certain regulatory functions of the Minister of Commerce and the then Ministry of Economic Development.

The FMA regulates securities exchanges, financial advisers and brokers, auditors, supervisors and trustees, providers of financial products (including KiwiSaver and superannuation schemes) to retail customers and jointly oversees designated settlement systems in New Zealand together with the Reserve Bank of New Zealand (RBNZ). In addition, the FMA's efforts are invested in building and strengthening the capability of investors. It undertakes market analysis and provides guidance, works to improve investor awareness and regulatory engagement, and informs the market and investors regarding its expectations.

New Zealand's financial markets regulatory system reflects the "twin peaks" model of conduct and prudential regulation. The FMA is the principal conduct regulator, while the RBNZ is the prudential regulator and is responsible for promoting the maintenance of a sound and efficient financial system. Under the 2011 FMA Memorandum of Understanding with the RBNZ, the FMA and the RBNZ expect to cooperate in areas of common interest where cooperation and coordination results in the most effective and efficient regulation of the New Zealand financial system.

The FMA oversees a range of financial markets regulation. It also has certain powers, monitors compliance and investigates and enforces conduct that may constitute a contravention of other legislation where it applies to financial market firms and individuals.⁴

Below, we comment further on two Acts that sit at the heart of the conduct regime.

Financial Markets Conduct Act

Establishment of the conduct regulator model is largely a result of substantial review and reform of NZ's financial markets and securities laws between 2011 to 2014. These reforms resulted in the FMC Act.

The FMC Act heralded a step change in the quality of regulation of capital markets. It included, among other things, major changes to the scope of securities law (ie the definition of securities and exemptions from securities law), the disclosure regime for issuers of securities and the regulation of managed investment schemes. Significantly, the FMC Act is a key part of the legislative foundation for conduct regulation of financial markets.

As noted in the regulatory charter of the NZ Council of Financial Regulators⁵, a central principle of the conduct-based approach to regulation is ensuring on-going high standards of professional conduct and boardroom governance. This is in contrast with a system that relies only on periodic disclosure and enforcement for breaches of the law. Among other things, the FMC Act provides for minimum standards of behaviour in relation to financial products and services. It is important to note, however, that the conduct regime under the FMC Act focuses on publicly listed securities and investment products sold to retail customers. Currently, the regime does not extend into consumer financial services such as retail banking and insurance. As discussed later in this report, this is set to change.

Currently, market conduct regulation focuses on ensuring customers are adequately informed and that market participants act with integrity, with a focus on product disclosure and the behaviour of financial services

⁴ A full list of relevant legislation can be found at <https://www.fma.govt.nz/about-us/what-we-do/our-role/legislation/>

⁵ NZ Council of Financial Regulators, Regulatory Charter p7.

providers. The general approach is one of having a principles-based set of duties. This gives the law flexibility to deal with a wide range of conduct, business models and technology. By the same token, however, providing flexibility requires the regulator to engage with industry, set clear expectations and hold institutions to account when regulatory requirements are breached.

The principles-based approach to conduct regulation is resource intensive. This is because it relies on high levels of engagement between the regulator and the regulated with the aim of identifying and reducing risks posed to investors, markets and customers before they crystallise into harm for these groups. It stands in contrast to the regime that existed prior to the FMC Act which, at that time, relied more on ensuring investors were provided with information coupled with enforcement for non-compliance with regulatory rules.

Financial Advice Regime

The Financial Services Legislation Amendment Act 2019 (FSLAA) received Royal assent on 8 April 2019. When it takes full effect, the FSLAA will repeal the Financial Advisers Act 2008 and insert into the FMC Act the new regulatory licensing regime for financial advice. The Government's overarching objective with the reform of the financial advice legislation is to improve access to high-quality financial advice for New Zealanders and establish a level playing field of regulation for all financial advisers.

The FSLAA removes the three current financial adviser types – Registered Financial Advisers (RFAs), Authorised Financial Advisers (AFAs) and Qualifying Financial Entities (QFE) advisers – and requires all financial advisers to meet the same standards under the FSLAA. This change is expected to bring approximately 7000 RFAs into the FMA's licensing regime, a population which the FMA has limited understanding of, as RFAs have not been within the FMA's licensing ambit previously.

To implement the new licensing requirements required under the FSLAA, the FMA is administering two phases of the licensing process. The first phase involves transitional licensing. The processing of transitional licence applications started on 25 November 2019. Any financial adviser providing financial advice to retail clients from 29 June 2020 (the start of the new regime) is required to operate under a financial advice provider licence. The second phase is the full licensing regime and that is set to commence in June 2022.

The FSLAA introduces a number of new statutory duties including a requirement to comply with a new Code of Conduct for Financial Advice that sets the standards of conduct and client care and competence, knowledge and skill. The FSLAA also introduces new disclosure requirements, with draft Regulations having recently been published for feedback.

It is important to note that the FMA has not yet received any funding for establishing or administering the new regime.⁶

Conduct and Culture Reviews – Retail Banks and Insurers

In 2018, a joint conduct and culture review was conducted by the FMA with RBNZ to establish whether 11 banks had adequate governance and risk management frameworks in place to prevent, detect and remediate misconduct, and ensure good customer outcomes. Whilst the Conduct and Culture (C&C) banking report did not identify systemic misconduct, it did conclude that there was lack of focus being placed on customer outcomes and lack of prompt and comprehensive remediation of misconduct where this occurred.

Specifically, the review found significant variation in the maturity of banks' approaches to identifying, managing and remediating conduct risks and issues. Overall, weaknesses were identified in the governance and management of conduct risks and significant gaps in the measurement and reporting of customer outcomes.

A similar review was undertaken of life insurers. The findings were largely similar, though the life insurance industry, as a whole, was in the FMA's (and RBNZ's) view determined to be significantly less mature from a conduct perspective when compared to the banking industry. A specific finding relevant to the insurance sector was poorly aligned sales incentives, and oversight of and accountability for conduct in third-party distribution channels.

⁶ We note that the FMA recovers the cost of processing licence applications with a fee paid by applicants.

These weaknesses leave customers of New Zealand banks and life insurers vulnerable to misconduct and to the issues seen in other jurisdictions.

The FMA and RBNZ provided detailed feedback to the individual banks and life insurers and directed them to develop plans to address the identified shortcomings, including undertaking any remediation activity of customers affected by poor conduct. The FMA undertook to review the plans developed by banks and life insurers and to undertake targeted follow-up to ensure plans are adequately and effectively implemented.

The FMA has established follow-up targeted monitoring of existing supervisory touch-points with banks and life insurers to gain more insights into sales and advice processes within these organisations, and to test whether their conduct and culture action plans are being actively and effectively implemented.

The follow-up activity to the C&C reviews being undertaken by the FMA will continue to have resource and funding implications. These have been explicitly incorporated into baseline Options 3 and 4 (and, to a much more limited extent, Option 2) that are discussed further in Part B of this report.

The C&C reviews also highlighted the known gaps in conduct regulation in relation to banks and insurers and provided a number of suggestions for government to consider in addressing these gaps. These included establishing basic legal duties on banks and insurers to address the systems and controls requirements referred to above, and providing regulators with sufficient supervision and enforcement powers and resources to address these issues and incentivise appropriate behaviour, as well as clarifying accountability and individual responsibility for management of conduct. The recommendations in the C&C reviews led to the recent announcement by the Government in relation to the new conduct remit.

We draw attention to the work that the FMA has undertaken in relation to banks and insurers as part of the background to the FMA for several reasons. First, it is important to note that, currently, the FMA does not have an explicit legislative mandate for the regulation of the conduct of banks and insurers. On the back of the Hayne Royal Commission, and reflecting the provenance of the largest of NZ's banks and many of its insurers, the findings from Australia raised obvious questions regarding the state of play in New Zealand. Notwithstanding the lack of formal mandate, it is clear that the FMA (in conjunction with the RBNZ) needed to act.

Second, and in light of the work done by the FMA and RBNZ, legislation has been recently introduced (11 December 2019) to regulate the conduct of banks, insurers and non-bank deposit-takers. This will be a substantial expansion of the FMA's remit and it is a good example of the evolving nature of the regulatory environment and the FMA's remit. This point is addressed further in the baseline funding section of our report.

The third point to note is that the work in relation to conduct and culture in the banks and insurers was a substantial undertaking. At the peak, the FMA had in the order of 31 FTE staff working on the conduct and culture reviews. Not surprisingly, this had the effect of diverting a considerable amount of resource away from other roles, activities and projects. This needs to be noted because it has impacted on some of the FMA's performance measures and has implications for baseline funding.

Legislative and policy reform

Currently a number of workstreams, legislative reforms and policy reviews and new initiatives are underway and/or coming into effect. In addition to the new FA regime and the intention to expand the FMA's remit to include conduct regulation of banks, insurers and non-bank deposit-takers, various other changes are on the near term horizon.

These include:

- new regimes for financial markets infrastructure (FMI) and benchmarks
- changes to the KiwiSaver default providers regime and, potentially, the FMA's role in monitoring default providers
- insurance contracts law reform.

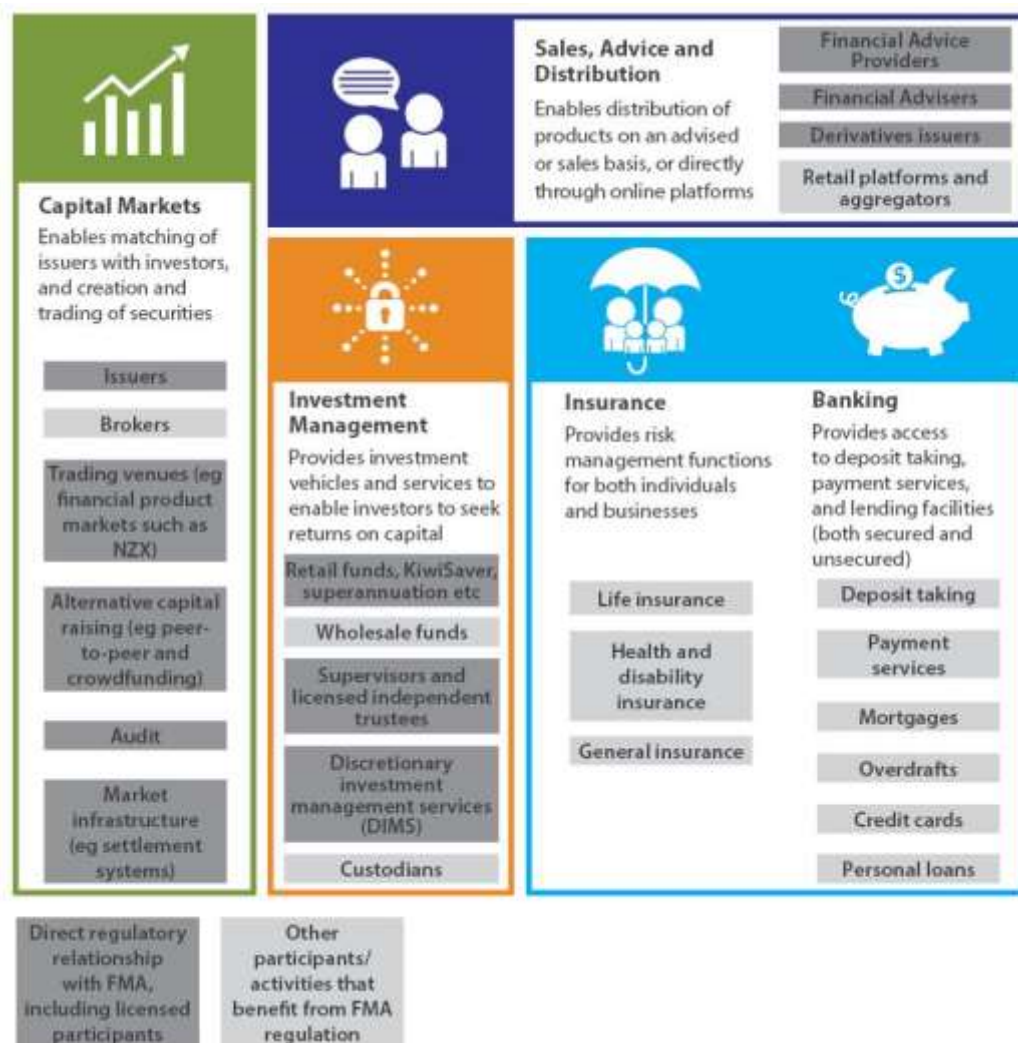
These changes will require a significant effort from the FMA to implement, along with the need to instil related behavioural and structural change from market participants (a significant portion of which is currently lacking in maturity). The effort will have funding and resource allocation implications.

The Minister of Commerce and Consumer Affairs (the Minister) also recognises in his Letter of Expectations (LoE) that the previous reforms under the FMC Act together with the new FA regime (and now including the recently announced new conduct remit, and ancillary changes outlined above) will mean that this will be a very demanding time for the FMA adapting to, and implementing, these regulatory changes.

Who the FMA regulates

The FMA's regulatory landscape is divided into sectors, which provide the basis for the FMA's assessment of risks. Figure 1 below outlines these sectors and describes some of the roles, activities and product types covered within the FMA's remit.

Figure 1: Sector map



The extent of the FMA's oversight varies across these sectors. The FMA directly or indirectly regulates, authorises or influences the behaviours of these various sector participants whose functions in the market touch the lives of many New Zealanders. By implication, effective regulation of these sectors by the FMA has significant ramifications for the overall wellbeing of all New Zealanders and provides context to how wide the FMA's impact can be.

FMA's strategic priorities

The FMA's recent 2019 Strategic Risk Outlook (SRO) outlines the FMA's medium term view (three to five years) of the most significant risks to promoting efficient and transparent financial markets.

The SRO identified five strategic priorities which underpin the FMA's regulatory approach. These five strategic priorities ensure that the FMA focuses activity to those areas where there is the greatest opportunity for achieving fair, efficient and transparent financial markets and reducing harm in financial markets. Set out below are the five strategic priorities and associated outcomes that the FMA wants to see in the medium term.

1. **Governance, culture, systems and controls:** regulated firms exhibit a customer centric culture that serves the needs of customers' interests. In particular, regulated firms have appropriate governance, incentive structures, sales and advice processes and systems to manage conduct risk.
2. **Credible deterrence of misconduct:** the FMA deters misconduct through effective enforcement action, particularly in relation to trading misconduct (eg insider trading and market manipulation), misconduct on the FMA's perimeter, failure to meet anti-money laundering and countering financing of terrorism (AML/CFT) requirements, and misleading and deceptive conduct (ie enforcing fair dealing provisions of the FMC Act).
3. **Successful implementation of remit changes:** delivering policy objectives while minimising transitional costs to regulated firms and risks to customers – particularly in relation to the new FA regime and the new conduct remit.
4. **Investor and customer decision making:** investors and customers are engaged and make active choices based on clear, concise and effective information.
5. **Promoting trust and confidence in capital markets:** promoting trust and confidence through improved quality of audit, disclosure and financial reporting and effective oversight of NZX and other licensed capital-raising platforms.

FMA's regulatory stance and approach

The FMA's broad regulatory remit covers numerous entities, activities and investor and customer groups. The FMA operates in an environment characterised by constant evolution of products, firms and regulatory remit. In order to be effective and influential in this environment, the FMA seeks to adopt the following principles to underpin its regulatory approach and guide its regulatory decisions (and we note that these align well with the Government's expectations for effective regulation):

- **intelligence-led and harm based:** the use of intelligence to identify and assess the areas of greatest harm to investors, customers and financial markets, and the drivers of that harm
- **outcome-focused:** focusing resources on where the FMA has the greatest opportunity of achieving desired outcomes and reducing harm. The FMA considers the most appropriate action for each situation, recognising the limits of its powers, and considering regulatory burden and potential unintended consequences of its actions
- **consistent and transparent:** clearly communicating intentions and expectations to market participants
- **flexible and responsive:** adapting and responding quickly to changing market conditions
- **a systems view:** the FMA promotes an integrated and coordinated approach to financial markets regulation in New Zealand
- **effective and efficient:** the FMA regularly reviews the use of its resources to enhance effectiveness and efficiency.

This approach invariably involves choices and trade-offs such as:

- the level of market engagement and guidance provided to encourage behavioural change and compliance with requirements vs enforcement action to punish compliance breaches and deliver credible deterrence
- the choice between proactive and reactive
- entity level or issue-specific thematic monitoring
- the resources put into industry vs investor engagement

- being visible across the whole market place (ie casting a wide regulatory shadow over the various financial markets stakeholders) while undertaking deep dives in areas of specific concern.

What is not tradable is the FMA's reputation. The FMA's ability to influence and guide behaviours is only sustainable to the extent that the FMA is able to retain its reputation and therefore credibility. Maintaining reputation and credibility is identified by the FMA as one of the most acute pressure points in the midst of responding to its increased remit and legislative change, in addition to its existing baseline workload.

Government expectations

The Minister's LoE to the FMA dated 26 February 2019, outlined the Minister's specific expectations for the FMA in 2019/20:

1. ensuring effective implementation of the new FA regime, particularly ensuring robust processes are in place for licensing and monitoring of financial advisers
2. working with MBIE on the policy response to the C&C reviews to ensure that banking and insurance conduct is of appropriate standard
3. promoting with other agencies and organisations, the effectiveness and integrity of the KiwiSaver system, with a strong focus on provider transparency and engagement with investors, particularly around fees and default funds
4. anticipating and enabling innovation in financial services, while also ensuring appropriate safeguards are in place and investors are adequately informed about any risks in the innovation may pose
5. maintaining appropriate oversight of the financial sector, including a robust approach to licensing and ongoing monitoring and supervision
6. proactively monitoring conduct risks affecting vulnerable investors who might be the targets of scams or fraud
7. supporting the passage of the International Financial Reform Amendment Bill, particularly ensuring robust processes are in place for licensing and monitoring financial benchmark administrators
8. coordinating with MBIE, the Commission for Financial Capability and any other agencies across government where appropriate to build investor capability and confidence, including by encouraging access to information and advice.

The strategic priorities identified by the FMA in its Strategic Risk Outlook align with the Government's expectations, although the speed, breadth, efficiency and depth of achieving these expectations will largely depend on which baseline funding option will be adopted.

Introduction

In this section of the report we:

- assess whether the FMA is focused on the right activities in support of its main statutory objective
- assess the extent to which resources are being used effectively and efficiently
- comment on opportunities for improving efficiency and effectiveness.

Is the FMA focused on the right things?

Objectives and Outcomes

In order to determine whether the FMA is focused on the right things, there needs to be a clear sense of what it is trying to achieve.

The FMA's statutory purpose is to promote, and facilitate the development of, fair, efficient and transparent financial markets. To this end, and as recorded in its latest Statement of Intent (SoI), the FMA wants to:

- strengthen public confidence in financial markets
- promote innovation
- support the growth of NZ's capital base
- balance costs and benefits (part of which is ensuring that regulatory burden is not disproportionate to the benefits expected from regulatory intervention).

The FMA's work contributes to broader governmental aim of creating a more competitive and productive economy.

Overall, we consider there is good alignment between the FMA's activities (and allocation of resources) with the objective and outcomes summarised above and, accordingly, we conclude that the FMA is focused on the right things. Our reasons for this conclusion reflect the following points (which are discussed further below).

- There is a robust process that supports the **development of strategic priorities**. At the heart of this process is a strong focus on identifying strategic risks (these are high-impact threats to fair, efficient and transparent financial markets).
- **Business planning and budgeting** processes support good alignment between the allocation of resources and strategic priorities.
- The **allocation of resources** aligns well with its statutory mandate. It also aligns well with priorities signalled by the Government through, in particular, the LoE.
- **Performance measures** underpin the FMA's purpose and provide a sound basis for assessing achievement of regulatory outcomes thereby providing an essential feedback mechanism that can then be used to reassess resource allocation.

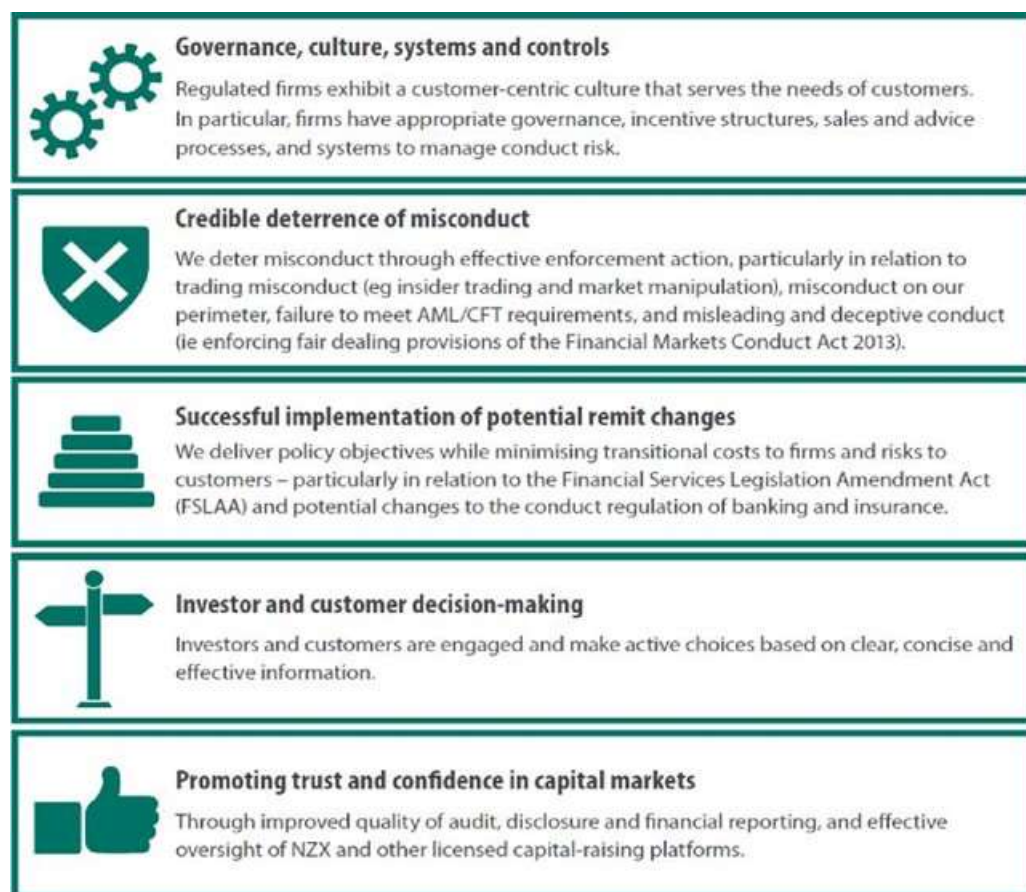
Development of strategic priorities

We consider the process used by the FMA to develop its strategic priorities to be effective. A key part of the process focuses on identifying strategic risks, which culminates in the SRO. The SRO provides a medium-term view (three to five years) of the most significant risks to, and opportunities for, promoting fair, efficient and transparent financial markets (ie in relation to the FMA's statutory objective).

The risk assessment process involves (among other things):

- breaking down the regulatory landscape into multiple sectors – this is important in part because different sectors can involve different types of risk but also because there are differences in what the FMA is trying to achieve in each sector
- undertaking PESTLE analysis⁷ to identify trends and developments of interest
- assessing the sectors using a standardised framework to identify risks, opportunities and outcomes drawing on a range of information sources including complaints, media coverage, information obtained through monitoring/supervision activities as well as insights obtained from other agencies both in NZ and internationally
- identifying trends and developments, sector and cross-sector risks, long term opportunities and challenges and sector outcomes
- testing the assessment internally, including with the FMA Board, as well as with external stakeholders including MBIE, the RBNZ and other parties (such as the NZX).

The output from the strategic risk assessment process is then used to help shape a draft set of strategic priorities. These are then tested in a workshop forum that includes FMA’s senior leadership team (referred to as “ExCo”) and tier three managers. Ultimately, the process delivers a set of strategic priorities that are then used to help guide business planning. The current strategic priorities are illustrated below.



Overall, the process leading to the determination of strategic priorities is a good one. The priorities themselves have strong alignment with the FMA’s statutory objectives subject to the following observation.

We note that the strategic priorities have a dominant focus on conduct and promoting trust and confidence in financial markets. However, the development (including growth) of financial markets is not explicitly addressed within the five strategic priorities listed above. The financial markets system has, at its core, economic growth

⁷ PESTLE analysis is a framework to analyse the political, economic, sociological, technological, legal and environmental factors that influence an organisation from the external environment.

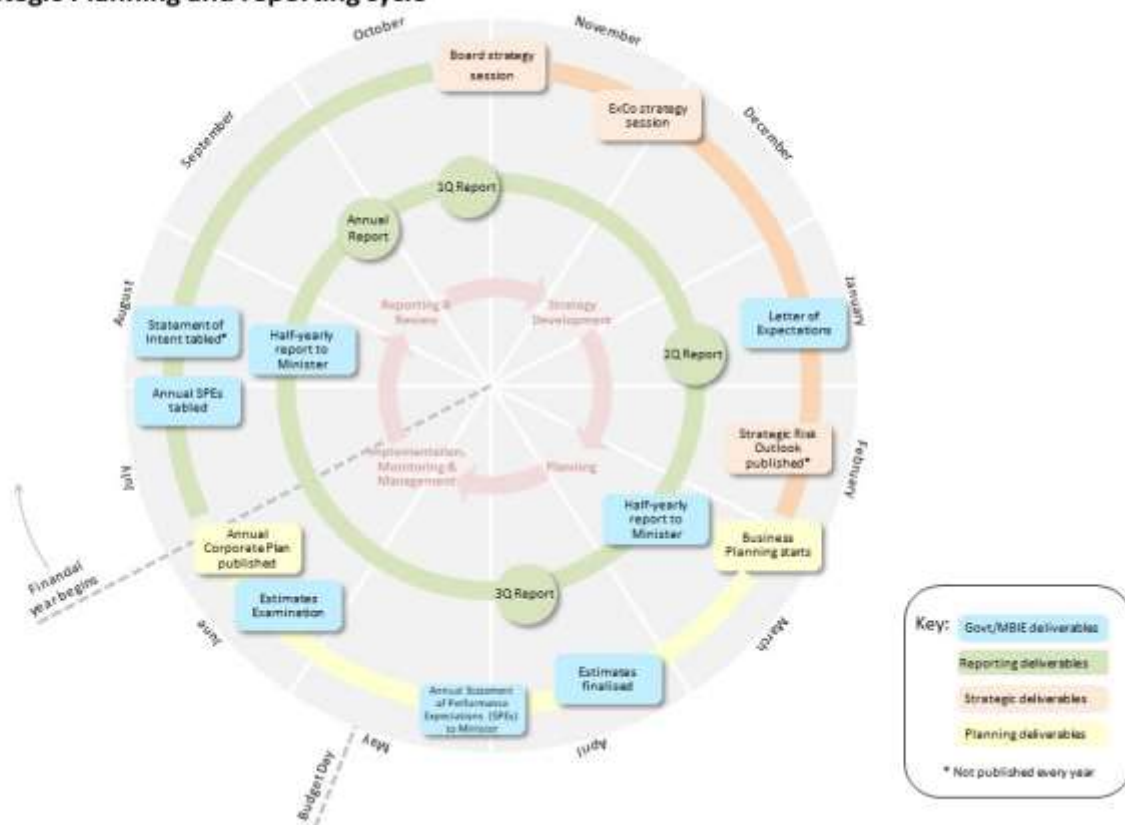
objectives and one of the principles applying to any regulatory system is that it should be growth compatible. The FMC Act introduced a new framework to allow easier forms of capital raising. Although the FMA has performance measures that relate to this, and a number of sector specific outcomes such as a capital markets regime that reflects best practice in facilitating innovation, we note that there is nothing explicit among the strategic priorities that talks directly to growth of financial markets and, hence, economic growth.

The SRO is also used to inform updates of the FMA's Statement of Intent (SoI). Like the SRO, the SoI also describes the regulatory outcomes that the FMA is seeking to achieve. The SoI also includes, however, performance measures that can be used to assess progress against strategic priorities. We note that the current SoI (which covers 2017-2020) refers to a previous strategic priority regarding capital market growth and integrity. In our view, it is important not to lose sight of this as it prepares to publish a revised SOI in 2020.

Business planning and budgeting

The FMA follows a business planning and budgeting process that is typical of most government agencies and reflects advice issued by the State Services Commission.⁸ It is summarised in the diagram below.

Strategic Planning and reporting cycle



The planning process starts with a strategic phase late in the calendar year with a Board Strategy session to provide strategic alignment for business planning.

Business planning typically starts around late February/early March and is informed by the SRO and the board strategy session, along with the LoE sent by the Minister of Commerce and Consumer Affairs.

⁸ State Services Commission (2014) Statutory Crown Entities – A Guide for Departments.

The business planning process culminates in the detailed business plans for each of the FMA's business units as well as the FMA's Annual Corporate Plan (ACP).

The purpose of the ACP is to provide the market with an overview of areas of activity and focus, and what the FMA will be doing, at a high level, to address areas of risk and make progress toward the achievement of strategic objectives. This includes setting out what outcomes the FMA is seeking achieve within sectors.

We commend the purpose of the ACP. As a public document, it provides a clear view of the FMA's priorities for the year ahead. This is important for the reason that better regulatory outcomes are likely to be achieved if those being regulated have a clear sense of what the regulator is wanting to achieve.

With respect to business unit plans, we note that these have good alignment with the FMA's strategic priorities and the priorities signalled in the LoE.

There are, however, two issues relating to the plans. The first of these is that there is not a consolidated organisation-wide business plan. In high level terms, the ACP is the external facing version of the organisational business plan. There is, however, no internal equivalent. Normal practice is to have an organisation-wide business plan that is more detailed than the ACP and that provides a consolidated view of the plans contained within individual business units.

The second issue concerns the integration of plans and budgets.

From an external stakeholder perspective, the ACP provides a good picture of organisational plans and priorities and the SPE provides summary forecast financial statements (as well as measures by which performance is reported). There would be some advantage in including financial information in the ACP particularly as the ACP is published after final budget decisions have been made. This would provide an opportunity to include up-to-date budget numbers which might differ, to some extent, from those in the SPE.

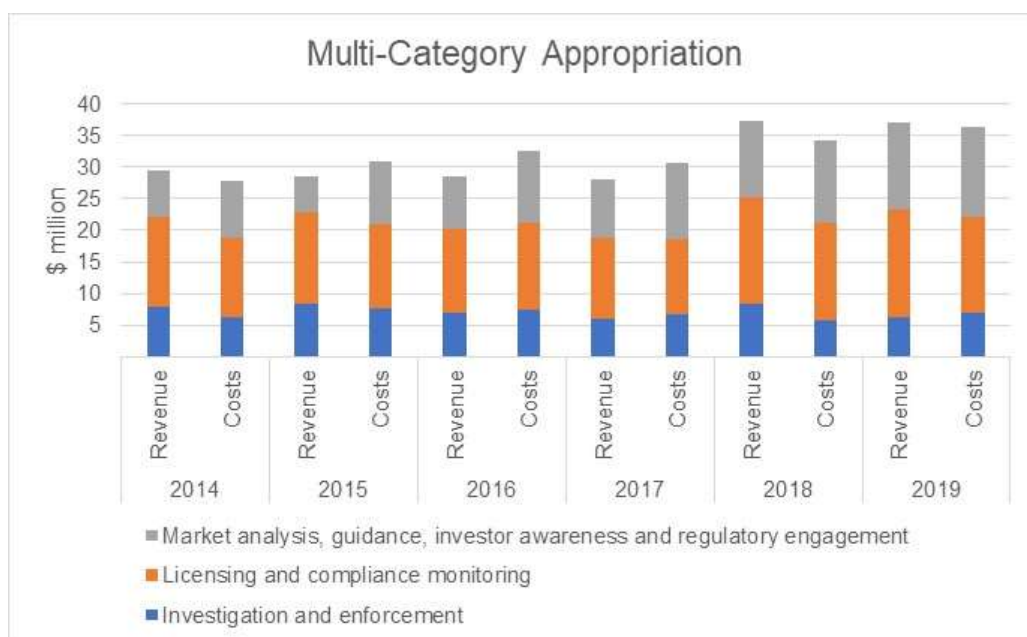
We note that business unit plans also do not include any financial information. This is not consistent with good practice. Plans should be self-contained in the sense of setting out the scope of activities, their timing and their resource requirements. We note that spreadsheets that are used to capture business unit plans include space to include FTE staff requirements. None of the plans we reviewed had populated the spreadsheets with this data and, moreover, no financial information is sought, or recorded.

In summary, business plans provide good alignment with strategic priorities and desired outcomes and, hence, assurance that the FMA is focusing on the right things. The lack of budget/resource information means, however, that it is much harder to assess, ex-ante, whether the relative emphasis across priorities is about right. Ex-post, however, there is a good standard of reporting that enables a better understanding of where resources are being deployed and we discuss this further in the following section.

Allocation of resources

The graph below summarises revenue⁹ and expenditure for each of the three categories that form the FMA's MCA. It should be noted that the graph below depicts financial years ending 30 June. Furthermore, the graph does not include a separate appropriation for litigation (and so excludes investigations and enforcement actions that are a charge against the litigation fund).

⁹ In addition to the government appropriation, revenue also includes interest (non-litigation) and other revenue (eg licence fees and audit quality review fees).



There are a few points to note.

A balanced allocation of resources

Overall, the graph above points to a balanced approach to the allocation of resources.

The largest area of expenditure is licensing and, more so, monitoring (which includes supervision). This is not surprising given the significant number of entities that need to be monitored and the diverse nature of the regulatory landscape (ie capital markets, investment management, sales, advice and distribution, insurance and banking).

There has been significant growth in the market analysis, guidance, investor awareness and regulatory engagement category. There are several drivers behind this including:

- significant and growing contribution to legislative and policy reform
- assisting the market in preparing and implementing these reforms through outreach and guidance
- a growing realisation that there needs to be focus on customers, as well as the more traditional focus on investors, fuelled by increasing concerns (expressed by government and others) regarding vulnerable investors and consumers.

The one area where we question the allocation of resources is investigation and enforcement. The amount spent in this area remained relatively constant over the period FY14 – FY17. Compared to the amounts at that time, however, expenditure in FY18 and FY19 is at a lower level in relative terms (and revenue in FY19 is about 15% lower than the average of the preceding five years). In FY19, investigations and enforcement accounted for 17% of revenue and 19% of costs.

Some care is needed with the numbers. Members of the FMA's supervision team also undertake investigations but not all of their time (and cost) is captured in these figures (something that needs to be addressed as part of a more general overhaul of time recording which is discussed later).

Notwithstanding this caveat, current levels of revenue and costs seem low. As regulatory schemes mature, we would generally expect the proportion of overall funding allocated to, and spent on, investigation and enforcement to increase rather than decrease. This is because as regulatory regimes mature, sufficient time has elapsed for market participants to understand and comply with their regulatory obligations which means that persistent non-compliers should expect to be subject to heavier forms of sanction (rather than further assistance to help them comply with their obligations). We note this point is reflected in the FMA's 2019/20

ACP which states that firms should expect a more robust enforcement response. We note also that maintaining a credible deterrence effect (through enforcement action) is one of the FMA's strategic priorities.

By way of final comment, we note that the FMA far exceeded its litigation fund budget in FY19 (incurring expenditure of almost \$3.0m compared to budget of \$2.0m). The Government has recently agreed to increase the FMA's litigation fund appropriation in FY20 to \$6m. Commensurate with this, we would expect to see relatively more of the MCA directed to investigation and enforcement over coming years.

Investment in systems and intelligence capability

The allocation of resources described above focuses on the split across the three main groups of FMA activity. Another way of considering the allocation of resources is the split between "front-line" and corporate support activities. Care is needed with this distinction because boundaries can become blurred; for example, expenditure on intelligence and data analytics can be viewed as front-line activity (ie a core part of regulatory activity) just as it can a supporting function. Moreover, different organisations tend to define front-line and supporting activities in different ways which means comparisons between organisations are not straightforward.

Notwithstanding the caveats just noted, we have reviewed the cost of core corporate support activities and compared this to overall organisational expenditure. Based on budgets for FY20, FMA anticipates spending a total of \$16.139 million on operations (this comprises finance, digital services and business performance and analysis) and people and capabilities. This figure represents just under 37% of total operating expenditure that is budgeted for FY20. That proportion is within the boundaries we have observed across a range of regulatory organisations that we have worked with.

Although the overall allocation of resources to corporate support activities looks to be reasonable, we note that historically the FMA has underinvested in technology including systems and intelligence capability. The historic under-investment was an area of concern identified in FMA engagement surveys and was widely viewed as being a brake on organisational efficiency.

In FY18 the baseline appropriation was increased by over one third (compared to the FY17 level) to \$36.0 million. The additional funding enabled, among other things, a range of enhancements to systems and intelligence capabilities. Over the last 18-24 months, the FMA has made a significant investment in technology to better support personnel and the activities they undertake. Examples include:

- providing personnel with more mobile and flexible ways of working (laptops, mobile phones, Microsoft 365 which brings together communications and collaboration software allowing FMA employees to work together easily with anywhere access)
- Relativity – which is an evidence management tool (also used by the Commerce Commission and Serious Fraud Office).
- SAS – which is an advanced analytics tool being used to automate processes and derive meaning from the large datasets available to the FMA
- upgrades to the FMA's core document and case management systems.

The investment in systems and people capabilities is contributing to improving knowledge management as a key element of being an effective intelligence-led regulator.

Notwithstanding the considerable catch-up investment, technology, systems and intelligence is still an area that offers the potential for further and significant gains in efficiency and effectiveness (as discussed further below).

Areas of unfunded activity

Although some of the additional resources helped the FMA to respond to the increase in its remit, the increase in demands being placed on the FMA have outstripped the amount of additional funding provided.

There are two major examples of this.

- The work that the FMA has been doing to set up the new FA regime has been undertaken within existing baseline; no additional funding has been appropriated for this development and no additional funding has been provided for ongoing supervision of the enlarged population of financial advisers.
- The reviews undertaken jointly with the RBNZ on conduct and culture in the retail bank and life insurer sectors have also been undertaken from within existing baseline.

These major areas of activity have diverted resources away from other activities and this has contributed to a significant amount of deferred work.

Deferred work

The work on the Conduct and Culture reviews, in particular, has consumed considerable FMA resources. Much of that resource has been diverted from business-as-usual roles, a consequence of which is there has been an increasing backlog of work that otherwise would have been undertaken but which has had to be deferred.

Examples of this include:

- reduced monitoring – in the first half of FY19 the FMA estimates it deferred:
 - 25 site visits relating to FMC Act monitoring
 - 15 site visits relating to AML/CFT
 - 50+ site visits relating to AFA/QFE monitoring
 - 2 site monitoring visits relating to MIS Supervisors
- deferred thematic reviews in relation to Discretionary Investment Management services, Derivative Issuers and wrap platforms
- around 75% fewer FSPR deregistration reviews
- fewer forums held with MIS supervisors and MIS Managers
- lighter stakeholder relationship management engagement
- work on building a better understanding of fee competition and practices across the KiwiSaver market was deferred to FY20.

Performance measures

The FMA's public accountability documents contain an array of outcome (SoI) and activity (SPE) measures that provide good insight regarding the organisation's performance. We discuss the performance metrics further in the sections dealing with effectiveness and efficiency. Many of the metrics are populated using information obtained through stakeholder surveys. The surveys include more granular information that supports the higher-level measures contained in the public accountability documents.

Overall, the suite of measures that are publicly reported is comprehensive. There is a good line of sight between the performance measures and the outcomes to which they relate. Collectively, they provide a good picture of the regulatory outcomes that the FMA is seeking to achieve and desired changes or trends over time. In this respect, the measures provide assurance regarding the extent to which the FMA is focused on the right things; for example, SoI 10 which measures the proportion of stakeholders who are aware of, and agree that, the FMA's activities target the appropriate risks. They also provide insight regarding the effectiveness of certain types of intervention (eg information provided by the FMA supports decision making by investors). However, the measures and the underpinning surveys do not, of themselves, provide much information to help assess whether the overall allocation of resources is about right or assess the efficacy of specific interventions.

We note that the FMA is currently reviewing its performance management framework ahead of preparing the 2020 SOI. This will include a focus on improving measures of outcomes. As part of this FMA may wish to look at mapping expenditure to outcomes. This would be assisted with changes to the way in which costs are recorded and reported – something we comment on further in the context of opportunities for improvement later in this part of the report.

Are resources being used effectively and efficiently?

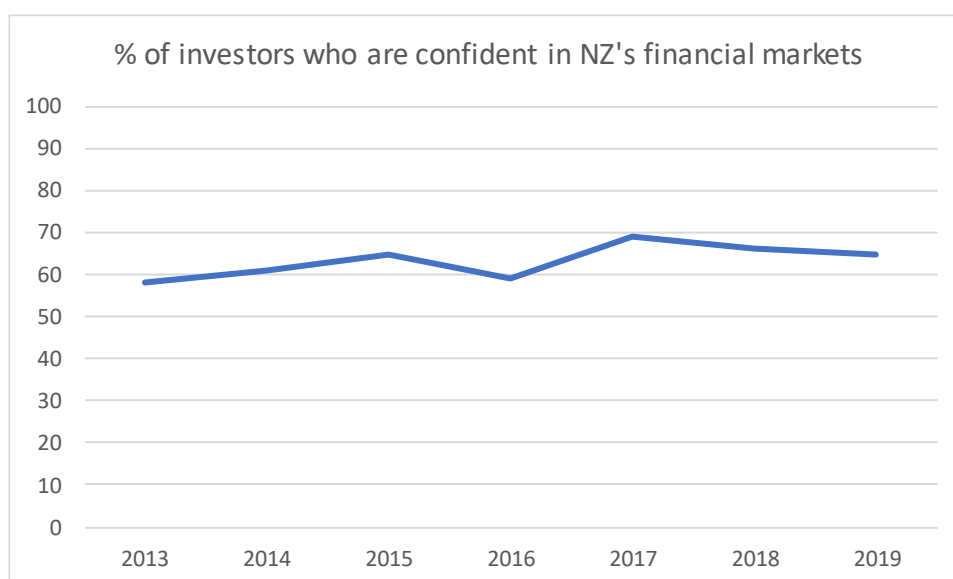
Effectiveness

Effectiveness refers to the relationship between the activities being undertaken and their contribution toward achieving the FMA's main statutory objective and associated desired outcomes; in short, the impact that stems from the FMA's activities.

The FMA publishes an array of measures that, to varying degrees, provide information regarding the impact that its activities are having in terms of confidence in financial markets and the efficacy of regulation of those markets. The following graphs paint a picture of high levels of confidence among investors and general recognition that the FMA has done, and continues to do, a good job of regulating financial markets.

Confidence in financial markets

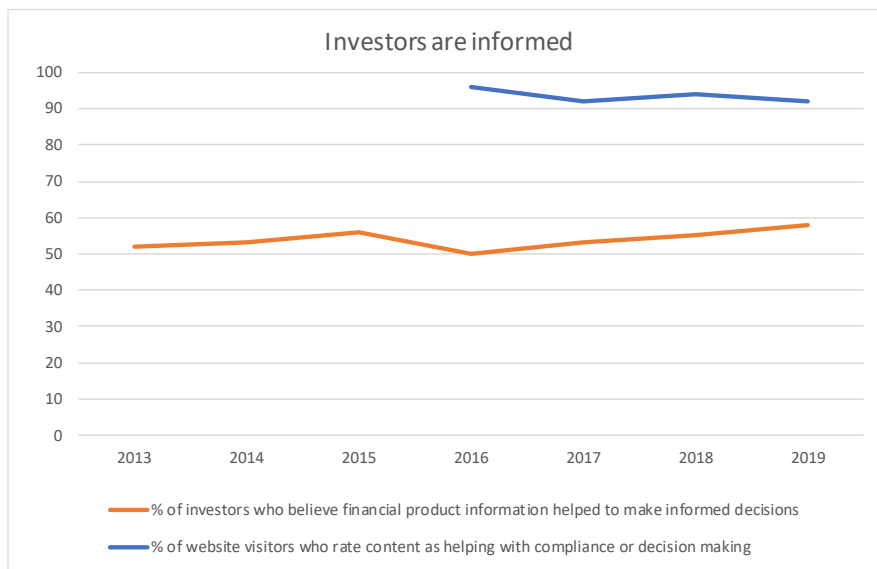
The overarching impact measure used by the FMA is the percent of investors who are confident in NZ's financial markets, as shown below.



The fact that confidence levels have remained relatively stable, with a degree of uplift since the early years of the FMA (when the transition to the FMC Act regime was yet to be fully completed), can be interpreted as a signal that the overall regulatory regime is reasonably sound.

Well informed investors

Confidence is a function of many things. One of these is access to robust information that assists with decision making. Information asymmetry is one of several fundamental reasons as to why markets, including financial markets, may fail to work well. The FMA has several performance metrics that shed light on the outcome of capable, confident and well-informed investors. Two of these are shown in the graph below.

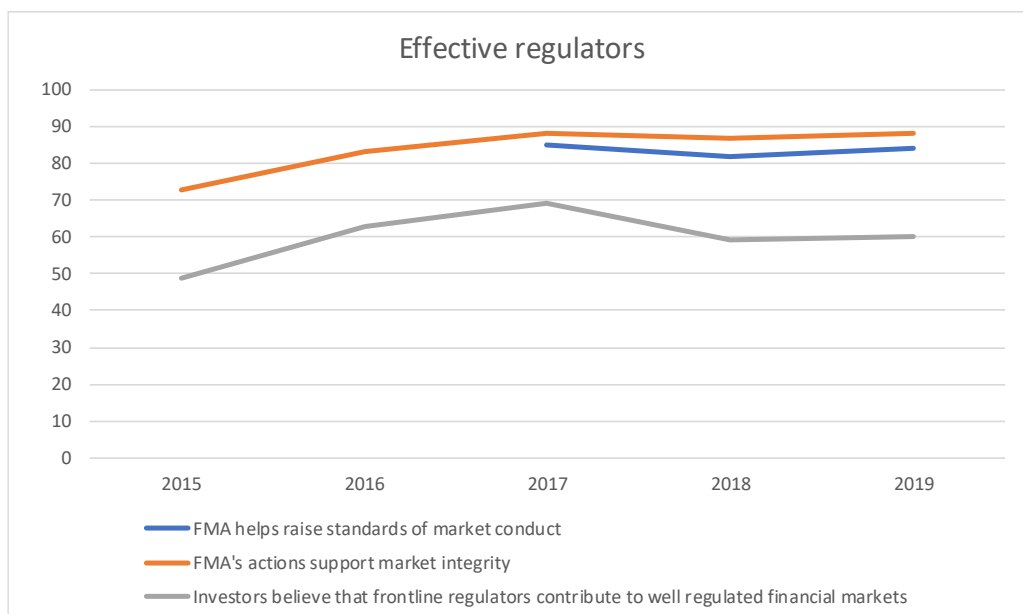


Indications from documents reviewed, and interviews conducted, are that the FMA does a good job making sure that investors can get reliable information on which to base their investment decisions. There are some suggestions that the FMA could make improvements, in particular around understanding the day-to-day practices of businesses and advisers in the financial sectors. However, there was no suggestion that the FMA was doing less than required.

A third measure focuses on the FMA's work with other government agencies and market participants to promote information and materials to improve investor capability. This measure has been achieved each year since it was first introduced in FY16.

Effective regulator

Surveys undertaken by the FMA dig a bit deeper to understand the views of investors regarding the work of the FMA and others in the regulatory regime and, in particular, on the contribution to lifting standards of conduct and integrity. Strong performance against these dimensions is important because one of the other main reasons why markets can fail is agency problems; that is, situations where the actions of the agent (eg providers of financial services and products) do not align well with the interests of principals (ie investors and customers). Conduct-based regulation aims to reduce agency problems. The graph below paints a positive picture in this respect.



There are a couple of points that can be taken from the graph above.

First, it would seem that the effectiveness of the FMA is regarded more highly by survey respondents than is the case for front line regulators. Front line regulators that are licensed or authorised by the FMA comprise the NZX, a small number of supervisors, licensed independent trustees and accredited audit bodies. Reflecting back across the FMA's Annual Reports over the last five or so years, there is a common theme of the FMA identifying a need for a range of improvements among the front-line supervisors which would seem to be consistent with the survey responses captured in the graph above.

Secondly, the fact that the FMA is viewed as making an effective contribution to lifting standards of conduct and supporting market integrity suggests that there are likely to be benefits from extending the FMA's remit into regulating the conduct of banks and insurers. More generally, a message we take from the graphs above is that effective regulatory oversight needs to be maintained, if not extended above current levels, because the FMA's oversight makes a difference.

Putting customer interests first

The FMA currently has three main indicators relating to customer interests. Performance to date has been good for two out of the three measures as summarised below.¹⁰

Measure	Performance
Licensed market participants show how they achieve good customer outcomes	This measure was introduced in FY18 with a target of 75% but compliance rate in that year was 47.8% and fell to just 20% in FY19 (it is important to note, however, that the sample size in FY19 was only 10 entities and these entities were considered to be high risk and, therefore low compliance was to be expected)
Conflict management procedures are designed to support customer interests	Compliance rates are estimated to be 18% FY17, 47.1% FY18 and 70% in FY19 compared to a target of 35% set in FY16
Market participants can demonstrate alignment of sales and advice processes resulting in good customer outcomes	Baseline of 38.7% set in FY18 and target of year-on-year improvement achieved in FY19 with 40% compliance

Capital market growth

Along with the NZX, the FMA initiated Capital Markets 2029. The review has developed a ten-year vision and growth agenda for capital markets. This is a very positive initiative.

The FMA's SoI includes one measure relating to capital growth: the FMA aims to facilitate the use of products, channels and processes that provide a lower-cost way to raise capital. The SoI performance measure used to report against this has been achieved in every year since 2016 when the measure (and supporting commentary) was first introduced.

Notwithstanding these achievements, we note that in comparison to 2016 when the FMA began reporting against the growth objective, this particular aspect of the FMA's statutory objective seems to receive less prominence currently. As noted earlier in our comments on strategic priorities, growth of capital markets is part of the FMA's statutory objective and, accordingly, warrants more prominence.

¹⁰ It should be noted that the sample sizes for some of these measures are very small so results need to be viewed as having wide margins of error.

Alleviating regulatory burden

Proportionality is one of the principles of effective regulation; that is, the level of regulation is proportionate to the level of risk (of harm). The concept of proportionality stems from the need to limit intervention (eg rules, sanctions and oversight) to what is actually needed to achieve the desired policy/regulatory objective.

The FMA reports two SoI performance measures that are relevant to the principle of proportionality. On both measures, the FMA has performed well.

One of the measures is “the FMA uses a range of regulatory tools to alleviate regulatory burden”. This includes, for example, granting exemption notices. Although there is no quantitative target attached to this measure, in qualitative terms this performance measure has been achieved each year since it was introduced in 2016.

The other measure is the proportion of stakeholders who agree that regulatory burden of the FMA is proportionate to the value of the FMA’s interactions (and broader impact on NZ’s financial markets). The FMA set itself a target of 65%-75% but so far has not achieved this level. The proportion of stakeholders who agree has, however, risen significantly; in FY14, only 34% agreed with the proposition but by FY19 the proportion had increased to 62%.

Collaboration

All of the measures reported above tend to focus on the FMA. The FMA is, however, part of a wider group of regulatory and enforcement agencies that have a role to play in regulating financial markets. The effectiveness of financial markets regulation rests in part, therefore, on how well the entities within the system interact.

This is an important issue because notwithstanding its small size, NZ has a very fragmented regulatory landscape in institutional terms. Reflecting this, there is considerable need for mechanisms that join-up the regulatory institutions in order to realise the benefits of the whole, as opposed to the sum of the parts. Effective bi-lateral and multi-lateral relations are a key part of the mechanisms that are required. In this regard, our overall view is that the FMA has worked hard to establish and maintain a wide network of relationships.

Without describing all of them, some of the more prominent bi-lateral relationships, reflecting strong alignment of mandate, include the following.

- The RBNZ is the other half of the twin peaks model of conduct and prudential regulation. The FMA and RBNZ worked closely together in the context of the recent conduct and culture reviews of retail banks and life insurers.
- MBIE develops financial conduct regulation policy and advises the Government on relevant issues. The FMA regularly engages with, and provides input to, the Ministry on a range of legislative and policy reforms.
- The Commerce Commission enforces laws relating to competition, fair trading and consumer credit contracts. Reflecting the natural overlap this has with the FMA’s remit, a memorandum of understanding exists between the two agencies to assist with avoiding duplication and encouraging collaboration where desirable.
- The Serious Fraud Office is primarily an enforcement agency with a focus on serious and complex financial crime. From time to time, matters coming to the attention of the FMA warrant referral to the SFO (either for the SFO to take over the case or for it and the FMA to work together on the case). There is a memorandum of understanding between the two agencies.
- The Department of Internal Affairs supervises AML/CFT requirements for designated non-financial businesses or professions and high value dealers and financial institutions not regulated by the RBNZ or FMA.
- The Commission for Financial Capability (CFFC) works to improve the financial capability of New Zealanders. The CFFC’s focus is predominantly on retail customers.

In addition to relationships with these, and other, agencies, the FMA is also a member of various groups with direct interest in the regulation of financial markets and regulation and enforcement more generally. Included among these are the following.

- The Council of Financial Regulators (CoFR) comprises the FMA, RBNZ, MBIE, Treasury and the Commerce Commission. This body provides a forum for a forward-looking focus of system risks and regulatory coordination by members. Within CoFR, there is a banking sub-committee that also includes the IRD and the Ministry of Justice and has a particular focus on the coordination and implementation of regulations relating to financial markets.
- The G-Reg initiative comprises multiple government departments and agencies including the FMA. The work of G-Reg is quite broad but has a strong focus on lifting regulatory capability.
- The Combined Law Agency Group (CLAG) has a particular focus on intelligence.
- The Government Legal Network offers a shared pathway of legal expertise and professional development (eg participation in specialised practice groups such as prosecution).

The FMA also collaborates internationally with agencies, to ensure it has a voice in setting of global regulatory standards and to enable the sharing of information and ensure that the FMA takes an informed and connected approach to its work. This includes:

- close engagement with the Australian Securities and Investments Commission (ASIC), with senior staff from both agencies attending bi-annual Trans-Tasman Emerging Risks Committee meetings
- membership of IOSCO the international standing setting body for securities regulators and a number of its committees and working groups
- attendance at the Financial Action Task Force plenaries, which is the international standard setting and oversight body for anti-money laundering and countering the financing of terrorism regulation.

Collaboration across the range of entities and fora takes many forms including those listed below.

Strategic engagement

Many issues that are confronting the FMA are also top-of-mind for other regulators. Examples include big data, technology and climate change to name just a few. Fora such as CoFR provide the institutional setting within which to consider and address financial markets regulatory issues (slanted more to a strategic rather than operational or tactical level). It also provides a forum for reviewing the financial markets regulatory system from time-to-time to ensure that it is meeting the objectives of the system, and if different objectives are needed.

Shared resources

A good example of this is computer forensic capability. The FMA together with the DIA, Customs, Commerce Commission and SFO came together to fund a technical specialist who can be used by any of the contributing agencies. This is a good example where no one agency had the workload or funding to warrant appointing a resource of their own; but by joining together, all agencies benefit from access to a capability they would otherwise not have had.

Secondments

The FMA and SFO have both seconded staff to each other as an operational or development need arises. There have also been secondments between the FMA and MBIE. Secondments are a useful way of deepening the understanding that each agency has of the other as well as fostering longer term less formalised relationships at an individual level that usefully complements the more formal organisation-to-organisation relationships.

Common systems

The best example of this is Relativity which is an e-discovery platform used as part of investigation case management. The Commerce Commission, SFO and FMA have all invested in this system. The FMA was the last of the three agencies to make the investment and benefitted from being able to leverage the experience that the other two agencies had already developed. The three agencies have recently formed a Relativity working group which involves bi-monthly meetings to address a range of technical issues.

Information sharing

As noted elsewhere, information is the lifeblood of any regulator. Moreover, information coming to the attention of one regulator will, in many instances, be of potential interest to other regulators if only for the reason that if someone, or an entity, is showing signs of not complying with their regulatory obligations in one area, it can be the case that they are also not complying with obligations in other areas.

Although the benefits of information sharing are potentially significant, there are considerations that place limits on the ability to share information. Different regulators operate under different rules in terms of their powers to obtain and use information. This means that in some instances, information collected by one agency cannot be used by others.

The effectiveness of the FMA's collaboration with others is measured by one of the SoI performance metrics: "the FMA works with other regulatory and government agencies to have a positive impact on NZ's financial markets, to reduce regulatory overlap, minimise gaps and increase efficiencies". This measure has been achieved every year since it was introduced in 2016.

Efficiency

FMA delivers a lot for the funding it receives. We note in passing that ASIC has a budget of slightly over \$400m (AUD). This is well in excess of ten times the amount of the FMA's funding and, while acknowledging that ASIC has some functions over and above those performed by the FMA, it is nevertheless an interesting comparison (and we understand that ASIC has recently received a funding increase that will take its budget well over \$400 million). Several external stakeholders interviewed as part of the Review have commented to the effect that the FMA "punches well above its weight" in terms of the level of activity (as well as impact).

We agree with this observation although there are some challenges when it comes to providing the evidence base. Examples of the challenges include the following.

- In some areas, activity is measured and reported (in accountability documents) in terms of meeting quality and timeliness standards rather than the volume/quantity (investigations and enforcement, as well as licensing are examples). This is because adherence to standards better proxies success than does volume. The lack of externally reported volume data makes it harder, though, to form a view on efficiency in a productivity sense.
- Where quantity measures are provided, they do not always give a sense of the scale of effort; the number of engagements and number of thematic reviews are examples.
- The definition of some of the activity measures has changed which makes it harder to assess over time whether the ratio of activity to input (ie efficiency) is increasing, diminishing or remaining roughly constant.

Notwithstanding these points, our view is that the FMA is efficient in terms of delivering a lot within baseline funding it is provided with. In support of this view, we note the following across each of the three main areas of activity.

Investigations and enforcement

- In every year since 2014,¹¹ the FMA has met or exceeded expectations in terms of conducting inquiries and investigations according to agreed timeframes and standards.
- Each year, information has been published on the key issues and themes arising from investigations and enforcement activity.

Licensing and compliance monitoring

- In every year since 2014, licence applications have been processed in accordance with established processes and timeframes.
- Each year since and including 2015, the FMA has been expected to conduct and report five thematic monitoring projects. In three of those five years, it completed and reported six thematic reviews. In the other two years – FY16 and FY17 – the FMA produced five and three reviews respectively.
- In all instances since 2014 where the FMA has found issues of material concern with disclosures of new regulated offers, the submitting parties have either addressed the issue or withdrawn the relevant documents.
- All FMA's licensing decisions (since 2014) have been unchallenged and upheld. Substantive feedback provided on licensing applications has resulted in improvements being made, applications being withdrawn or applications being declined.

¹¹ Where feasible, we have chosen 2014 as the beginning of the period reviewed as it was during FY14 the FMC Act was enacted and this legislation lies at the heart of the FMA's mandate.

Market analysis and guidance, investor awareness and regulatory engagement

- In 2016 and following years, the FMA has been required to undertake at least 20 industry, or business, presentations or speeches.¹² Over the four years, the FMA has delivered, on average, at least 27 (and in no year has it fallen below the target).

In addition to the specific measures noted above, we note that staff utilisation levels are high – in the order of 70%.

In addition to its “normal” range of activities, the FMA has also successfully completed some large and challenging projects. Notable major activities include the:

- conduct and culture reviews
- set up for, and implementation of, the new FA regime
- work in relation to the Warminger market manipulation case and follow-up industry engagement
- ANZ Ross Asset Management case.

¹² 2016 was the first year for this particular measure.

Opportunities for improving efficiency and effectiveness

Planning and budgeting

There is good line of sight between plans (at both business unit and ACP levels) and strategic priorities. However, planning and budgeting would be further strengthened if:

- there was a comprehensive annual organisation-wide business plan that is designed for internal management purposes in addition to the outward facing focus of the ACP
- plans also included budget (ie financial) and resource information.

These changes would enable a more comprehensive and integrated view of the organisation and where resources (including money) are being allocated. They would also enable individual business units (and people within those units) to get a better sense of how their work fits into the whole. Organisation-wide business plans also provide a better basis for Boards to hold the Chief Executive and the senior management team to account for overall organisational performance over and above the accountability of each senior manager for their particular part of the organisation.

Performance and management reporting

At an organisation-wide level, and subject to the point in the previous paragraph, the breadth and depth of performance reporting to external stakeholders is good. We particularly like the range of SPE and SoI performance measures that are reported in the FMA's Annual Reports. These provide a good overview of what the FMA has done (most of the SPE measures) and the impacts that stem from the FMA's work (all SoI measures plus a few of the SPE measures).

There is also good quarterly performance reporting provided to ExCo and the Board that tracks progress and performance against the FMA's ACP.

Below the level of the organisation as a whole, performance monitoring reporting is not as mature and is an area for further development.

The utilisation of personnel is key to the effectiveness and efficiency of the FMA. Having good information on where resources are allocated and being used, when and how much resource is required for an activity (or project), and where resources are either being over-stretched or under-utilised is basic management information. Without this information and the ability to analyse it, it is unlikely that the use of resources is being optimised.

Although the FMA has a time recording system, it is of limited usefulness.

FMA personnel (other than corporate support personnel) record their time against projects and "other activities". Other activities, which based on a recent study¹³ accounted for 71.6% of time recorded, comprise a mix of regulatory roles (supervision and monitoring, guidance and policy, offers and disclosure, risk assessment and intelligence, market engagement and investor capability) supporting functions (team management, learning and development, FMA governance, support) and leave and travel.

¹³ KPMG (2018) Time Recording System (internal audit performed for the FMA).

There are some limitations with this approach.

- The approach does not readily link to strategic priorities unless one of these happens to be categorised as a project (the conduct and culture review is an example of a priority that has been set up with its own time code). KPMG observed that the time recording system is not utilised as a performance monitoring tool for assessing progress against targets and priority areas. That said, however, we note that this issue appears to be, in part, a function of limitations with the system and, in part, a lack of capability to utilise the system.
- There are many small projects. This risks creating a situation of not being able to see the wood for the trees. The 2018 report prepared by KPMG noted that 169 of 200 projects included in the time recording system constituted, in aggregate, less than 5% of the time recorded. The FMA has advised, however, that this is largely driven by a time code being set up for each entity that is within the scrutiny of the supervision team. While that might facilitate management information on interactions at the entity level, that still comes at the expense of making it harder to understand resource use from an organisational perspective.
- There are issues with the suitability of time codes which can result in situations where staff struggle to find a code that adequately captures the nature of the activity being performed. The KPMG work observed that for many teams, their time tended to be recorded mainly against a single time code. While that might make time recording easier for staff, it adds little or nothing to the stock of management information.

In addition to these points, issues with the time recording system means it is harder to analyse the information that is captured. We note that the supervision team has developed a work-around solution to provide at least some evidence-based understanding of resource use. That team has a staff member who, as part of their role, has responsibility for undertaking performance analysis and reporting. In this instance, the system is used to assist with the management and allocation of resources.

The need to investigate options for enhancing the time recording system is recognised by the FMA. Work on an intelligence data warehouse (IDW) is intended to support SAS automation of this activity and replace the work-around used by the supervision team. This will deliver direct efficiency gains by releasing the time of team members to work on more value-adding activities, it will also deliver a more consumable and consistent end product. Importantly, the work being done will support development of similar reporting for other teams which hitherto they have not had because, unlike the supervision team, they have not had the resource needed to perform the analysis. To enable this, some further master data governance and management is required. Overall, however, development of the IDW should enable the FMA to get a much more sophisticated understanding of how resources are used and how to optimise their use.

Technology

Although the FMA's investments in technology in recent times have been substantial and have delivered important benefits, they are coming off a low base. Historically, the FMA has not invested in technology and information systems to the extent that would normally be expected. There are opportunities to deliver gains in efficiency and effectiveness through further investment.

There are three areas where technology has an important role to play in lifting efficiency and increasing effectiveness.

Process improvement

Although it has not been within the scope of the Review to undertake detailed assessment of the FMA's business processes, we note that like other regulators, the FMA has to deal with increasing amounts of data and information.

Information comes into the FMA and then someone or some people have to do something with that information. There are multiple pockets of manual and relatively simple tasks being performed throughout the organisation (eg filing documents). In general, this is fertile territory for efficiency gain by mapping processes and then identifying opportunities to streamline and automate those processes. Technology can assist with all of these tasks.

The FMA is aware of the opportunities in this area and, as a result of a stocktake of its business processes in 2018, is currently trialling Promapp's business process mapping software. One of the very first use cases for SAS has also been to introduce automation to a previously manual licensing process.

Knowledge management

A review undertaken for the FMA in early 2018 assessed the organisation as having relatively low knowledge management maturity. The low level of maturity reflects not just technology but also people capabilities and behaviours. Among other things, the review identified low levels of confidence with the tools (which led to work-arounds), issues with where knowledge management sat in the organisation and issues with governance and management of the knowledge management function.

The FMA is on the journey to addressing these issues. As part of a mid-term maturity target, the FMA has:

- established a leadership position (Head of Knowledge Services) and a knowledge management team, within the regulation division thereby bringing this role much closer to the front-line and providing greater critical mass and support across the organisation (knowledge management was previously a single position within the IT team)
- established a knowledge management committee to provide oversight
- refreshed its knowledge management strategy and developed a roadmap for giving effect to the strategy and prioritising what needs to be done
- strengthened training in knowledge management
- moved all parts of the organisation onto CLaRE, which is a contact and case management system¹⁴ (until recently not all parts of the organisation were linked to CLaRE).

In addition, the FMA has recently introduced Relativity¹⁵ to sit alongside its case management (CLaRE) and document management (Tiaki¹⁶) systems; it is also embarking on a digital transformation journey.¹⁷

Although all three of these systems serve distinct purposes, the information contained within them overlaps. This has the potential to create inefficiencies (eg having to maintain multiple systems and staff having to access multiple systems) and potential problems as a result of there not being a single source of the truth.

Given that this duplication of content is deliberate and necessary (ie to protect the integrity of evidence), there is a need to ensure that the systems operate well together and staff have adequate training in their use. The digital transformation project should look to ensure that the integrity of the information contained within the systems is protected whilst also allowing for ease of data/information transfer and discovery.

Continued development of the individual systems (ie CLaRE) should also occur. Although significant progress has been made, capability issues still remain. For example, although there is an advanced search capability within CLaRE, it is not possible to search on a thematic basis due to the underlying data design.

Intelligence

Data and its analysis, to create intelligence, is the life-blood of being a regulator. Intelligence is a critical part of being able to identify where the risks of harm are greatest and determining the optimal regulatory strategy and tactical response.

Key to further gains in efficiency and effectiveness, and lifting the FMA to a high level of knowledge management maturity, is the introduction of SAS and the new IDW. The IDW is built but there are important tasks ahead. One of these is cleansing the data to be housed in the IDW. This includes improving the

¹⁴ All market-facing work undertaken by the FMA is recorded in CLaRE (eg when a complaint is received by the FMA it is lodged in CLaRE).

¹⁵ Relativity is an evidence management tool used, for example, to organise and manage case files.

¹⁶ Tiaki – is a content management system and has records management capability. Information that is not case-related is captured into Tiaki.

¹⁷ As part of the digital transformation strategy, Relativity, Tiaki and CLaRE are being migrated to the cloud (consistent with wider all-of-government IT strategy).

consistency of data, removing extraneous or duplicate data, ensuring that data is fit-for-purpose and ensuring that metadata is accurate and available. The other important task is building the models that will be used to interrogate the data and create useable intelligence.

There are some achievability and affordability challenges. A major challenge in terms of achievability is getting the experts needed to undertake the model builds. This is a specialised skill and the FMA is hitting up against competition from other agencies (eg Inland Revenue) that are seeking to procure the same skills. Potentially, data cleansing may also be a significant challenge if only because of the volumes of data involved.

The other major challenge is affordability. In short, the FMA does not currently have the financial capacity to invest further in the IDW notwithstanding that, taking into account sunk costs, the benefit to cost ratio of making further progress is likely to be high. Once the models have been developed, the potential gains are likely to be broad and substantial.

The issue of affordability applies more generally (ie not just to the IDW), and is discussed further in Part B of this report.

People: Learning and development, on-boarding and HRIS

Much of the process for on-boarding recruits and supporting their ongoing learning and development is quite time-intensive involving face-to-face engagement. While not diminishing the importance of this, there is plenty of scope for on-line modules to support on-boarding and learning and development more generally. The advantages of making more use of e-learning include the following:

- less resource intensive
- more flexible (users can select when and where they work through the modules)
- readily scalable (increasingly important if the FMA is to grow significantly commensurate with the intended expansion of its remit)
- efficient, in that it enables the time of managers, coaches and others that are involved with on-boarding/L&D to focus on reinforcing what's being learned rather than providing the learning.

We note that the FMA does not have an HRIS. As a smaller organisation, the business case for investing in an HRIS can be marginal. However, as the FMA grows, reliance on ad-hoc/bespoke (eg spreadsheet-based) approaches to capturing and managing HR-related information becomes increasingly tenuous and inherently inefficient. The business case for investing in a HRIS is likely to be stronger as the organisation grows (although we note that none of the baseline options considered in Part B specifically allow for this).

People: Recruitment

Two of the baseline options considered in Part B of this report involve a substantial increase in the number of FMA personnel. The FMA's budget for FY20 is based on an annual average of 199 FTE staff. The "base" and "enhanced" baseline scenarios (discussed later) increase numbers to circa 265 and 285 FTE staff respectively. That presents a substantial recruitment challenge (albeit a challenge that the FMA has faced before following its establishment in 2011 and as the shift to conduct-based regulation under the FMC took effect).

We note that the SFO and Commerce Commission are also in the market to recruit similar types of capabilities to those that the FMA will need if the enhanced (or base) baseline option meets with ministerial approval. The opportunity is to collaborate, as much as is realistically feasible, across the three agencies (and possibly others including the Treasury and MBIE) with a view to growing the supply of suitable candidates rather than competing against one another.

The issue of regulators competing against one another for similar capabilities has been recognised by the G-Reg initiative. We understand the initiative is giving some thought to ways of tackling the challenge. Although we are not privy to where the thinking has got to, by way of example of specific initiatives, consideration could be given to joint international recruitment drives (assuming that at least some recruits will need to be sourced from overseas), and thinking about design of career pathways in a system sense (ie across agencies) as well as within individual agencies.

Introduction

Four baseline options have been developed and they are the focus of this section of the report. In brief, the four options are as follows.

Option 1 – No new funding option. Because the FMA is forecast to incur a financial deficit for FY20 and beyond, this option involves a reduction in expenditure (including a reduction in FTEs) and a cut in outputs compared to current levels.

Option 2 – Current spend option. Option 2 reflects the FMA's current level of expenditure plus some additional expenditure directed toward providing a bare minimum of resources for the new FA regime. However, it does not address broader cost pressures across the FMA.

Option 3 – Base option. Option 3 involves additional funding of up to \$21.6m by FY24 and enables the FMA to deliver, for the most part, against its current remit and future remit in relation to financial advice.

Option 4 – Enhanced option. This option also involves additional funding of up to \$26.3m by FY24. In addition to Option 3, this option enables the FMA to shift toward a wider systems approach to its work, a greater focus on consumers and, to a small degree, to begin the process of transitioning to the new conduct regime (although comprehensive preparation for the new regime and its implementation will require further funding).

Background – financial situation and resources

Revenue

Multi-Category Appropriation

The FMA's primary source of revenue is a multi-category appropriation (MCA) from the Crown. The current appropriation is \$36 million per annum. This funding is appropriated under three categories of output as follows (the allocation of revenue reflects that in the FMA's SPE for 2019/20).

1. *Investigation and enforcement functions (\$6.196 million).* This category is limited to the performance of FMA's statutory functions in relation to the investigation and enforcement of financial markets legislation, including the assessment of complaints, tips and referrals.
2. *Licensing and compliance monitoring functions (\$16.072 million).* This category is limited to the performance of FMA's statutory functions in relation to licensing of market participants and risk-based monitoring of compliance including disclosure requirements under financial markets legislation.
3. *Market analysis and guidance, investor awareness and regulatory engagement functions (\$13.732 million).* This category is limited to the performance of FMA's statutory functions in relation to market intelligence, guidance, investor education and regulatory and government cooperation and advice.

Other Revenue

In addition to the \$36m Crown MCA, the FMA also generates “other revenue”. In FY19, this amounted to approximately \$0.721m broken down as follows:

- audit quality review fees (\$0.263 million)
- licence fees comprising application fees and hours charged for additional work performed (\$0.323 million)
- sundry revenue from pecuniary penalties, gains in fixed asset sales and secondment fees (\$0.119 million)
- superannuation fees (\$0.016 million).

Litigation Fund

There is another, and separate, appropriation for the FMA’s litigation fund. When the FMA was established in 2011, the appropriation for the litigation fund was set at \$2.0 million. The Government has recently announced that for FY20 the fund is being increased to \$6.0 million. The litigation fund is Crown funded. This appropriation is limited to meeting the cost of major litigation activity arising from the enforcement of financial markets and securities markets law, or defending litigation action taken against the FMA. We do not comment further in this report on the litigation fund given the recently announced increase for FY20.

Expenditure

Based on the FMA’s FY19 financial results, total expenditure was approximately \$39.2 million (representing an overall financial deficit position of c.\$172k in FY19) broken down as follows:

1. personnel expenses (c.\$24.4 million), which includes salaries and wages, contractor expenses, ACC levies, member and committee fees and recruitment costs
2. depreciation, amortisation and impairment losses (c.\$2.1 million) on property, plant, software and intangible assets used by the FMA for its operations
3. other operating expenditure (c.\$9.7 million) which comprises fees paid to Audit New Zealand for financial statements audit, operating lease expenses, professional services fees, services and supplies (which are mainly ICT expenses) and travel and accommodation
4. litigation fund expenditure (c.\$3 million) – the FMA noted the major variation of the litigation fund against budget was due to the number of large litigation matters undertaken during the past financial year. The FMA noted that this deficit is not funded from the litigation appropriation, instead it was funded as a one-off from the FMA’s operating fund and its historical reserves.

Financial deficit

In FY19, the FMA incurred a small deficit of \$0.172 million. In FY20, however, the FMA is forecasting a much larger deficit of \$4.245 million. The increase in deficit compared to FY19 reflects expansion of the FMA’s mandate that has not been matched by any increase in funding, growth in overall levels of activity and cost pressures. The FMA is forecasting the deficit to widen further in out-years as a result of additional roles and responsibilities including the new financial advice regime and the new conduct regime.

FMA Personnel

The FMA budget for FY20 is based on 199 fulltime equivalent (FTE) staff. This is the average budgeted FTE for FY20 and this figure may differ from the actual number employed at any point during FY20. The teams to which personnel are assigned is shown below.

Team	FTE allocation
Supervision and monitoring	48
Intelligence & knowledge management	13
Enforcement and investigations	23
Policy, governance and legal	26
Capital markets	26
Stakeholder and strategy	6
External Communications and investor capability	10
People and Capability	9
Operations	22
CE/Risk and audit	7
Conduct and culture follow up	9
New Financial Advice regime (<i>refer paragraph below this table</i>)	0
Total	199

It should be noted that a significant number of personnel have been taken away from their normal duties to assist with implementing the new FA regime and, as part of this, engaging with the financial advice sector. The table above does not take this into account. These personnel largely sit, and are accounted for, within the supervision and monitoring teams.

It should also be noted that the 9 FTE staff allocated to conduct and culture is for follow-up work only. They do not represent the project team that will be needed to fulfil the FMA's roles in relation to the recently announced intention to extend the FMA's remit into regulating conduct in the bank and insurance sectors.

Personnel costs account for around two thirds of total operating costs (excluding costs that are charged to the litigation fund). Attracting and retaining high calibre personnel is critical to the effectiveness of the FMA as a regulator. The FMA currently faces a highly competitive and tight labour market, creating both recruitment and retention pressures. The FMA has noted that:

- its remuneration levels do not match private market levels of remuneration in some career levels
- people in the financial services industry are in great demand currently – financial services and other businesses are competing with the FMA to find the same types of skill sets which results in a pull from external industry for resources within the FMA
- due to the difficulty of finding talent in such a specialist financial services industry, the FMA is mitigating this pressure with a strategy of hiring talented individuals who may not necessarily have financial services backgrounds and training them, which subsequently makes them more employable and sought after in the external market, making retention challenging
- even if the FMA is successful in finding new people it takes time and investment upskilling and teaching new individuals to develop a regulatory mindset

- the change in the FMA's regulatory remit (new conduct remit and FA regime) requires more effort from the people already within the FMA and this has ramifications on the level of resilience that the current FMA staff can sustain with the increased workload and pressures which leads to retention pressures
- the turnover rate in 2018/19 saw a return to levels last seen in 2016 - mitigating actions are in place, but turnover remains a constant focus for the FMA.

Given the pressure points identified above, the ability of the FMA to achieve the outcomes envisaged for the base and enhanced options will be largely dependent on the FMA's ability to retain their current staff, find new talent and upskill in time (as experienced in the last funding round, where people retention and recruitment were significant challenges to implementation of the changes under the FMC Act).

Option 1: No new funding

Overview

The no new funding option represents a decrease in current FMA expenditure at a time when the FMA's remit is expanding significantly. Based on current cost estimates, this would require a headcount reduction to an annual average of 160 FTEs over a three-year period.

Given much of the FMA's regulatory activity is interconnected, and its approach is scalable rather than modular, a reduction in expenditure is likely to have impacts across the board. Overall, this option would result in a far more reactive regulator with a narrower focus, and one that was slower to respond to events when they did occur.

Current funding pressures would be significantly exacerbated, in areas such as supervision, policy and governance, investigations and enforcement. Frontline activity would need to be refocused on the FMA's core mandate; that is, its licensed and authorised population. Sectors where reductions in activity are likely include banks and insurance (ie conduct and culture follow-up) and monitoring of the perimeter (ie FSPR monitoring). Even within the core licensed and regulated population, a more reactive stance would mean less monitoring in areas such as Derivatives Issuers, Discretionary Investment Management Services (DIMs), Crowdfunding and Financial Advice and less work in areas such as disclosure and financial reporting.

The need to implement the new FA regime, and maintain a minimum follow-up of banks and insurers would require reallocation of staff, requiring even further reductions in supervision, monitoring of licensed entities and market engagement activity. In addition, the FMA would have less capacity to undertake sector wide, issue specific thematic work.

Less engagement and communication with, and guidance to, entities and industry is likely, as is less engagement and communication with investors and customers, along with slower response times to queries and complaints.

Less and slower enforcement action is also a likely outcome with less resource to devote to investigating and preparing for formal action.

Capacity would be limited in areas such as innovation and climate change and efforts reduced in cross agency collaboration and coordination potentially increasing costs on industry and systems inefficiency.

Assessment

Alignment with government priorities and expectations

The FMA's statutory objective is to facilitate the development of fair, efficient and transparent markets. Success in pursuing this objective requires a regulator that can identify potential harm and act effectively before risks crystallise across a very broad regulatory landscape. It also requires the use of a wide range of tools to influence market participants' behaviour, and the capacity to deploy the right tool to bear at the right time. The no funding option would undermine these necessary capabilities and would, therefore, reduce the FMA's ability to meet this objective and fulfil other statutory responsibilities. This would ultimately undermine the ability to achieve the Government's financial markets policy objectives, including those related to the implementation of the new FA regime.

It could also ultimately undermine wider government policy objectives across a number of areas, including increasing retirement savings, encouraging home ownership, enhancing investment in businesses, encouraging innovation and addressing climate change. Effective regulation of capital markets and the funds management and financial advice sectors is a critical condition to achieving these broader policy goals.

This is within a context of not only an expanding FMA mandate, but increasing expectations. Since its establishment, government and societal expectations of the FMA's role have expanded. Recently, these have been driven by the Australian Royal Commission and subsequent FMA/RBNZ joint reviews of Conduct and Culture in banking and life insurance. This has seen the FMA extend its activity into areas beyond its core mandate of regulating securities and investment products, into a more customer-focused consumer protection space such as banking and insurance. This option would severely constrain the FMA's ability to continue to meet these expectations.

Support for strategic direction

The no new funding option would undermine the FMA's ability to pursue its strategic direction not only directly by reducing available resource to address specific events, but also indirectly and over the longer term by undermining its ability to continue to develop and deliver an effective regulatory approach.

Risk (or harm) to investors, consumers, markets and regulators

The narrower, more reactive approach necessitated by the no new funding option would reduce the speed of responses, increase the risks of harm crystallising across the remit, ultimately undermining confidence in regulation and markets reputation to attract and retain investment. It may also increase overall risk of harm from giving consumers a false sense of security.

The ongoing assessment of compliance and risk under the FMC Act is, therefore, limited as is the speed that the FMA can influence behaviour, which requires sustained effort and attention over a long period. This is at a time of increased concerns regarding the lack of conduct maturity across the market (as evidence by recent thematic work on insurance churn and the C&C work).

A reactive approach is, by its nature, a more enforcement-based approach. This is likely to create a more litigious regulatory environment and, potentially, increase the overall costs of regulation across the system. Similarly, reduced market engagement would result in less regulatory certainty and increase regulatory burden.

Implementation of the new FA regime would be slower and with significantly less market engagement, potentially limiting speed and effectiveness in realising policy objectives of the new regime. Lack of resource would limit understanding of the market and areas of concern and increase the risks to consumers and the credibility of the new regime.

The no new funding option is also likely to increase operational risks to the FMA. For example, through decelerated ICT spending which may increase data security risk and reduce effectiveness.

Resilience and future-proofing

The option would seriously undermine FMA capability, capacity and its ability to respond to future demand and shocks. Even at current expenditure levels the C&C work required a significant reallocation of resources from across the FMA, resulting in the deferral of a number of important work streams.

General capability is likely to erode as the organisation struggles to deliver across an expanded remit, with little resource to devote to capability maintenance and building.

Similarly increased pressure and workload on staff may undermine attractiveness of the FMA as an employer leading to recruitment and retention challenges.

Value for money

Option 1 means cuts in expenditure. However, this does not translate into value for money because the savings in FMA expenditure are more than offset by imposing costs elsewhere. Moreover, Option 1 will create substantial loss of benefits that stems from eroding the effectiveness of the FMA and of the regulation of financial markets. The erosion will lead to substantially higher levels of misconduct and harm, and increased risk of loss of confidence in markets.

Over the longer term, reduced regulatory oversight is likely to lead to a build-up of undetected risks in the system that may ultimately crystallise. The history of financial crisis suggests that the costs of dealing with these crises ex-post tend to be significantly greater than seeking to mitigate the risks at an earlier stage through proactive intervention.

Option 2: Current spend

Overview

Option 2 is an option that essentially maintains current levels of activity. The internal budget forecast expenditure for FY20 is \$41.803 million with 199 FTE staff. Option 2 continues the operations of the FMA at this level plus a modest amount of additional funding for the new FA regime (which involves adding 12 FTEs). Taking this into account, expenditure in FY21 is \$44.601 million. Expenditure in FY22 and FY23 increases slightly above this figure reflecting cost escalation. Taking into account existing baseline funding and other income, the additional baseline funding required for Option 2 in FY21 is \$7.673 million (growing to an increase of \$11.098 million by FY24).

The financial implications are summarised below. It should be noted that all financial years are year ending 30 June.

Operating funding \$m*	FY21	FY22	FY23	FY24
Forecast expenditure (Option 2)	44.600	46.007	46.768	47.845
Less current baseline funding	(36.000)	(36.000)	(36.000)	(36.000)
Less other revenue	(0.928)	(1.933)	(0.748)	(0.748)
Additional funding for Option 2	7.673	8.073	10.020	11.098

* Numbers may not add precisely owing to rounding

Capital funding \$m	FY21	FY22	FY23	FY24
Funding for Option 2	3.300	-	-	

The capital funding is sought to fund several projects:

- level 4 Auckland office set up and fit-out for new headcount: \$0.8 million
- new website development: \$0.5 million
- significant systems build for banking and insurance: \$2.0 million.

The contract for occupying the Auckland office is signed, so the fit-out will need to occur. The systems for the banking and insurance work include new regulatory forms (ie for licensing), new CLaRE cases, new internal reporting requirements and integration of, and between, the systems.

The operational impacts of Option 2 are summarised as follows.

- Option 2 continues the activities of the FMA at largely the same level. The main impact is a greater focus on prioritising activities, limiting these to pursuing the FMA's core mandated activities and being reactive rather than proactive.
- The risk and harm in the financial system is likely to increase. The FMA will be spread over a larger mandate with responsibility for more customers and advisers, and with heightened expectations, but with a small amount of additional resources. There will be proportionally less market engagement, less enforcement and less monitoring and supervision.
- The FMA will implement the FA regime, with an initial focus of monitoring on the firms and advisers that are considered most likely to be problematic. Full coverage of the industry will take several years.
- There will be some follow-up on the conduct and culture review but less than Options 3 and 4.
- Strategic engagement across government will continue (eg with CoFR), but will not increase to match increasing demand, or government expectations.

- Some activities will need to be deferred (as is the case currently). The conduct and culture review led to several activities being deferred, and a lack of new funding does not allow for catch-up. The FMA would continue to prioritise and triage its activities.

What Option 2 funds

The amount of funding needed each year for Option 2 is summarised below, and the following table indicates FTE staff by year.

Operating funding for Option 2 (\$m)*	FY21	FY22	FY23	FY24
Personnel costs by function				
Supervision	6.931	7.061	7.218	7.407
Intelligence and knowledge management	1.877	1.912	1.955	2.006
Enforcement and investigations	3.321	3.384	3.459	3.549
Policy, governance and legal	3.755	3.825	3.910	4.012
Capital markets	3.755	3.825	3.910	4.012
Strategy and stakeholder relations	0.866	0.883	0.902	0.926
External communications and investor capability	1.444	1.471	1.504	1.543
Financial advice regime	1.733	1.765	1.804	1.852
Conduct and culture	1.300	1.324	1.353	1.389
People and capability	1.300	1.324	1.353	1.389
Operations	3.177	3.236	3.308	3.395
CE/Risk/Internal Audit	1.011	1.030	1.053	1.080
Other costs				
Professional services	2.476	2.551	2.647	2.672
Organisational support and infrastructure expenses (occupancy, IT, depreciation, supplies, travel)	11.655	12.415	12.392	12.615
Subtotal (expenditure)	44.600	46.007	46.768	47.845
Offset from other funding	0.928	1.933	0.748	0.748
Net total (funding)	43.673	44.073	46.020	47.098

* Numbers may not add precisely owing to rounding

FTE staff for Option 2	FY21	FY22	FY23	FY24
Supervision	48	48	48	48
Intelligence and knowledge management	13	13	13	13
Enforcement and investigations	23	23	23	23
Policy, governance and legal	26	26	26	26
Capital markets	26	26	26	26
Strategy and stakeholder relations	6	6	6	6
External communications and investor capability	10	10	10	10
Financial advice regime	12	12	12	12
Conduct and culture	9	9	9	9

FTE staff for Option 2	FY21	FY22	FY23	FY24
People and capability	9	9	9	9
Operations	22	22	22	22
CE/Risk/Internal Audit	7	7	7	7
Total	211	211	211	211

Supervision

Under Option 2, supervision, enforcement and investigations continue at roughly the current level. The risk-based and engaged approach will continue, with no deepening of relationships or further development of the regulatory approach. There is likely to be less engagement with financial providers as discretionary activity is reduced.

The C&C reviews have identified lower-than-expected levels of conduct maturity in the banking sector and, more so, among the life insurers who were reviewed. Based on this and other monitoring activity, the FMA's view is relative immaturity is a real possibility (or likelihood) across other insurers (ie not those involved in the C&C reviews) and other sectors more generally. FMA's regulatory activity is already having an impact; for example, in changes to incentives for staff in the banking industry. However, the FMA believes that there is considerable work to create a consistently high level of customer-centric conduct and culture, and that some market participants are likely to resist changes. In Option 2, there are staff dedicated to follow-up work but not at the levels used in the review. At the peak of activity (May 2018 to January 2019) the FMA had 31 FTE staff engaged on the reviews. The impact on banks' and insurers' conduct and culture is uncertain, because the level of effort required is unknown. Option 2 allows the work to continue, but possibly not to the level of expectations among government and customers.

Other supervision activities will continue. The thematic reviews will continue, although they could be reduced in number, with topics identified in the usual process. AML and other activities will continue. Work on KiwiSaver will also continue, although the exact level of work on fees, default scheme and other issues has not been determined. There is likely to be some KiwiSaver work that is de-prioritised in the short term.

Since its formation, the FMA has actively sought to work alongside the industry and engage with people and companies to help both develop and publicise its expectations of market participants. This is particularly the case during the implementation of new regimes or changes in regulatory requirements. This engagement model requires a lot of staff time to stay connected and be available to discuss emerging issues. The level of engagement will need to be adjusted to fit within the Option 2 budget. It will not be a wholesale change of approach, but a pulling back toward being less available and responsive.

Intelligence and knowledge management

The intelligence-led and risk-based approach to regulation will continue, as will the work to improve internal information management and knowledge management. The work will continue at the current pace or more slowly, depending on the allocation of resources.

The assessment of the FMA team involved is that the push to change intelligence and knowledge management has lost some momentum. In particular, although systems and tools have been acquired or developed, the behaviours and processes required to embed them into daily operations have not occurred. The FMA intends to make this a focus.

Option 2 does not provide any additional resource, so the work will continue as it has. In general, this is likely to mean that the FMA will make improvements in information and knowledge management, but that the pace of change will be slower than both desirable and necessary. Training and behaviour change are likely to occur but only as staff are able to free up time from their usual activities.

There are essentially three impacts.

- The focus on, and behaviour of, wrapping up work and moving on to the next project will continue.
- The systems will not be used to full capacity, because staff will tend not to populate them with information and will tend to use existing work-arounds.
- The benefits of connected information and knowledge systems to support an information-led approach will not be fully realised.

Enforcement and investigations

The FMA will continue with its risk-based approach to enforcement, targeting the areas of greatest likely harm and taking a proportionate response. The absence of any increase in expenditure might lead the FMA to tighten its settings around enforcement activities and the level of harm required to trigger action. Extension into perimeter activities will be curtailed in favour of focusing on the core of its mandate.

We note that a shift towards implementing a tougher enforcement strategy has already occurred in Australia after the Hayne review implying it would not be out of step for the FMA to take a similar approach. However, under Option 2, the FMA would lack the resources to enable this.

Policy, governance and corporate legal

One of the main roles of the Policy and Governance team is to provide input to law reform. Past and current examples of this include the Financial Services Legislation Amendment Act, Financial Market Infrastructures Bill, Financial Market Conduct Act regulations, and the RBNZ Act Review.

The Corporate legal team provides support to other areas within this FMA. For example, this includes the provision of legal services in relation to (but not limited to):

- issuing licences and authorisations
- granting exemption and designation applications
- the use of regulatory tools
- enforcement
- review of guidance, reports, thematic reviews
- implementing new laws and law reform
- policy development.

The pressure points in the current Policy, governance and corporate legal area are mainly around knowledge management, staffing and the increasing remit of the FMA. As the remit expands, these pressures are likely to increase. Option 2 does not provide any resources to make improvements in this area – the pressure points are likely to remain.

As part of the engagement model noted above, the FMA often issues guidance notes to clarify issues proactively for firms across the financial sector. This is a discretionary activity for the FMA, and it would likely be reduced in order to deal with resource pressures. This change would represent a shift from an engaged approach with the sector towards a more enforcement approach. This approach is undesirable leading into the new FA regime as the population is likely to need significant guidance. Furthermore, a lack of market guidance could also undermine the move to principles-based regulation for this sector.

Capital markets

The Capital Markets team focuses on conduct (ie risks of market manipulation and insider trading and oversight of NZX), disclosures of information to investors, reporting of publicly listed and financial firms and audit in the capital markets.

Much of the work is discretionary, and Option 2 is likely to affect the level of effort. The guidance and disclosure advice, for example, is somewhat discretionary. Option 2 is likely to result in fewer publications providing advice as the FMA scales down discretionary activity. In addition, the FMA runs a pre-disclosure review service in which it reviews draft disclosures and provides advice. This activity is entirely discretionary: it is essentially a

service provided at no charge to the sector, although it does have the effect of making the FMA's formal disclosure process easier. This work could also be scaled back without affecting the FMA's legally required work. To some extent, the team will back off a partnership approach to working with businesses, which is resource-intensive. As a result of these changes, businesses will face more uncertainty regarding their activities, and possibly more enforcement actions if they miss the mark.

The team will look at further prioritisation. Market misconduct investigations, which includes insider trading (considered to be particularly important), market manipulation, continuous disclosure and fair dealing will be prioritised over monitoring. Furthermore, investigations will be closed earlier if probability of success is lower.

In general, the FMA will move toward being more reactive. The focus on prioritising activities implies that some work is deferred, perhaps indefinitely. That is, the FMA will identify areas of potential (or actual) harm but will decide that it does not have the resources to investigate them or conduct enforcement around them. Already, there are indications of what that might look like because of the conduct and culture review. The FMA is clear that the conduct and culture review was additional to its expected activities. In order to pursue the reviews, other work was deferred. In the Business Plan Activity Reporting, FY19, for the Capital Market Disclosure group, four activities are highlighted as off-track because of the conduct and culture review. Those activities are thematic monitoring of fees, thematic monitoring of exceptional returns, thematic monitoring of poor market practices and a lead review concerning price competition in KiwiSaver. These are issues that had been identified as requiring further investigation, but they were not investigated because the FMA's activities were re-prioritised.

We are not in a position to have an opinion about the re-prioritisation; we expect that the FMA used its expertise to make that judgment. However, important work was deferred. Holding to the current level of funding will lead to more work being deferred.

Strategy and stakeholder relations

The FMA has been increasing its engagement with other regulators and taking a leadership role in CoFR. It has been taking a more collaborative approach with other organisations, such as the RBNZ and NZX. It has also focused on building relations with its international counterparts, most notably ASIC, to identify emerging risks and share best practice. In Option 2, there is likely to be less contact and less appetite for proactively engaging on issues. Again, this is a move toward a more reactive regulator.

Systemic risks – the risks of financial market activities not being addressed because of lack of co-ordination – will continue.

External communications and investor capability

External communications and investor capability work will continue at the current level. Communications with the professional investing community will continue at the current satisfactory level. This is distinct from the likely reduction in providing guidance and engaging proactively with the population of regulated firms and individuals noted above, with the adoption of a more reactive stance and a more enforcement-based approach.

The investor capability work is a key part of the shift from 'investor' to 'customer'. There is a large (and growing) number of people who have investments but who would not consider themselves to be investors (eg among those who participate in KiwiSaver). Furthermore, the extension of the new FA regime will cover more consumer type products such as insurance and mortgages. Many of the people using these products and services are not financially well informed or literate and, moreover, may be poorly served by financial organisations. This work is likely to continue but at a reduced level.

Supporting the expert investor is much more about providing information, such as making material available on a website, while the investor capability work requires a greater level of engagement with a wider range of people. In addition, the potential harm per customer is lower simply because the level of investment is lower. Option 2 will require the FMA to consider the effort-to-harm ratio, which is likely to mean less work in the investor capability area. This is particularly true because this work overlaps with the remit of the CFFC; reducing potential overlap is one way the FMA can prioritise its activities.

Expert investors are likely to see some impact from the lack of proactive guidance, probably in the quality and timeliness of information they receive. Non-expert investors will continue to be exposed to risks of high fees and poorly targeted products, and the FMA will not increase its activities to communicate with them.

Financial advice regime

The successful implementation and operation of the new financial advice regime is one of the Government's key expectations of the FMA. The new regime will significantly expand the number of advisers covered by the licensing regime.¹⁸ A significant majority of these are former registered financial advisers (RFAs) who have not previously been licensed or monitored. The FMA is expecting that this cohort of financial advisers will have relatively low levels of conduct maturity and/or be negatively disposed to regulatory scrutiny. Moreover, because the former RFAs have not been subject to regulatory scrutiny, there is a need for the FMA to engage with this sector more so than would otherwise be the case. Stakeholder surveys undertaken for the FMA indicate that the more effectively the FMA engages with sectors and businesses, the more likely it is that those sectors and businesses will view the FMA as an effective regulator and, in turn, the more likely it is that they will respond positively to the FMA's interventions aimed at promoting better conduct.

Option 2 represents a minimal approach to the financial advice regime. The work that will be required is unknown but is expected to be significant. Option 2 starts the work and allows the FMA to identify high-risk/high-priority advisers, firms and behaviours.

There are two concerns, however. The first is the unknown nature of the population and associated issues. Based on what is known currently, registered financial advisers could require a lot of resource. Option 2, in general, takes a minimal approach across the FMA. Therefore, if resources had to be shifted into financial advisers work then other activities would be deferred, compounding the deferment from the past year.

The second concern is that a minimal approach to regulatory oversight will require years to reach a broad understanding of the sector and risks. Under Option 2, monitoring of financial advisers is very reactive with proactive monitoring limited to only the highest risk entities. There would be no regular cycle of proactively monitoring entities. Consumers will have the expectation that all financial advisers are being supervised when in fact, although the FMA will have licensed all providers, the FMA will have capacity to review only a portion of them – focusing initially only on those considered to be highest risk. This is potentially a time of maximum gap between expectations and actual regulatory oversight.

Option 2 will enable the financial advice regime to function. However, it will be limited and slow process, with potentially increased risk and harm during the phase-in period.

Conduct and culture

The conduct and culture reviews of banking and some insurance providers has identified behaviours and issues of concern and increased expectation on the FMA to address them. Option 2 provides some resources (9 FTEs) to continue this work. The scope of the work and specific activities have not been identified in this review. However, the scale of the issues identified in the reviews, the large number of customers potentially affected by these issues and the high profile of the work all point toward needing sufficient resources to quickly and capably master the situation.

Although Option 2 allows work to progress, we doubt that the resourcing is at the same level as expectations.

Organisational support and infrastructure

Option 2 provides funding for organisational support and infrastructure at the current level. This suggests that some of the known pressure points in the organisation are unlikely to be addressed. The two key pressure points of concern are staffing levels and training, and use of digital technologies, particularly for knowledge management.

¹⁸ Currently, there are approximately 2000 Authorised Financial Advisers (AFAs) and 57 Qualifying Financial Entities (QFEs). Under the new regime, in addition to these two groups, there will also be Registered Financial Advisers (RFAs) which currently number around 7000. Because the new regime is entity rather than advisor based, the number of licensed financial advice providers is estimated to be somewhere in the range of 2000-3000.

The current level of staffing, particularly with some large projects over the past two years, have led to high workloads and concern that staff in parts of the organisation are under stress. Workload and remuneration levels are considered unsustainable. Maintaining the current level of funding and staffing will mean either that the workload continues to be high, or that work needs to be triaged and the lower-priority work deferred. Without addressing the situation, the FMA risks burning out its staff and/or acquiring a reputation as a poor employer. Either development would make it more difficult for the FMA to hire staff, thereby reducing the resilience of the organisation. In addition, the FMA has recognised that training staff for their roles is particularly important. Without increasing organisational support, the ability of the organisation to develop its staff could be compromised.

Several parts of the FMA discussed the lack of digital tools to improve their productivity and effectiveness. The organisation appears to have a focus on the immediate work and to have little resources available for the type of investment required to obtain digital tools and embed them in the workflow of the organisation. Option 2 will continue this status quo. This is an area in which extra resource is required in order to get over the hurdle of deploying new systems. Without sufficient extra resource, the FMA will continue to use the tools it has rather than develop new ones.

Assessment

Strategic fit – contribution to investment objectives, meeting business need and integrating with other strategies, programmes and projects

Option 2 has a medium level of strategic fit. As noted in Part A of this report, there is good alignment between the FMA's current activities and its statutory objective. Option 2 enables current levels of activity to continue. Option 2 fits with the focus of the FMA on maintaining confidence in financial markets by ensuring good information, engagement and communication. It allows the organisation to continue to its work with the current remit. It also allows for some additional resource for implementation of the FA regime and some continued conduct and culture work. Under Option 2, the FMA is able to continue much of its work around disclosure, audit, supervision and other activities.

Option 2 is, however, only a medium rather than high strategic fit because it rates poorly in terms of alignment with expectations and the shift to a customer focus. The work on conduct and culture and other developments have raised expectation about the remit of the FMA and its willingness or ability to modify behaviours in the financial markets. There is a risk that the organisation will not meet expectations. In that case, there would be reduced confidence in markets among the general population and potentially less concern about the FMA in the regulated population. In addition, a shift to a customer focus brings with it a shift toward more engagement with a wider group of people. At the level of funding in Option 2, it is doubtful that the FMA can achieve the required level of engagement.

Critical to the FMA's strategic direction is having the capability and capacity to identify and proactively address emerging risks and harms. Option 2 makes no allowance for addressing current pressure points and increases in workload. It does not provide capacity to deal with emerging issues or provide scope for building capability and capacity (see below). This ultimately undermines the ability to deliver its strategic objectives.

Current pressures – alignment with demand and expectations

The FMA has identified some clear pressure points. Staff workload and training, digital tools, deferred work, and heightened expectation are all important issues. Option 2 does not provide resources to deal with these pressure points. It does not allow for investment in people, tools and process to overcome pressures and hurdles. There is some increased funding to support the increased remit, in particular around conduct and culture and the financial advisers. However, the level of funding may not be commensurate with expectations.

Capability building, resilience and future proofing

Option 2 does not address any concerns about capability building, resilience or future proofing. It would, arguably, lead to a degradation of capability and resilience. In the intelligence and knowledge management area, for example, there is no extra investment in systems and staff training. The use of enhanced knowledge management system is likely to proceed slowly, with staff relying on existing tools and capabilities rather than investing in developing new ones. Staff levels are essentially static while workload and expectations are expected to increase. The result is likely to be lower staff engagement and higher turnover rates, affecting the

resilience of the organisation. At the same time, other organisations and businesses will be adopting newer tools, technologies and processes, and regulated businesses will be developing new products and strategies. The potential is that the FMA will fall behind relative to these developments.

Impact from the market's perspective (what they get/do not get)

The impact on financial markets will be variable according to the type of firm and the type of investor or customer. The least impact is likely to be on large organisations with better-developed systems, as well as expert investors with good sources of market information. These market participants will continue to have the same level of trust in financial markets as they do now, and are likely to continue to have sufficient experience and transparency with respect to their transactions. Although these market participants will have less access to guidance information provided by, and less proactive engagement with, the FMA this may not matter much.

The impacts are likely to be felt elsewhere. New firms seeking information on participating in capital markets or wishing to issue disclosures are likely to find the process more challenging because capacity constraints limit the ability of the FMA to provide assistance and guidance.

Ordinary, non-expert investors are likely to continue to be at risk of being presented with products and services that may not meet their needs or provide good outcomes. They are also less likely to have access to good information about participating in financial markets. The customers of financial advisers, banks and insurers will see slow improvements in behaviours, products, conduct and culture in those sectors. The result is likely to be increased risk and harm for these investors.

Risks – regulatory failure, reputation

Option 2 represents an increase in risk. The FMA will have an expanded mandate – the FA regime in particular – but only a bare minimum funding to support operation of the expanded mandate. The FMA will not have resourcing to deal with the work deferred over the past two years. In addition, expectations in the public and government have been raised. The risk in particular is that the gap between expectations and achievable results continues, eventually having an impact on trust in financial markets. Ultimately this level of funding increases the probability of the build-up of the sorts of system risk that resulted in the initiation and fall out from the Australian Royal Commission.

Achievability – eg implications for change management, operating model, timing/phasing

Option 2 has high achievability primarily because it involves little change from what exists now. Under Option 2, resources remain at close to their current level and this is readily maintainable (subject to the point noted above regarding the risk of higher turnover). The FMA will be able to allocate its staff and effort across the many areas of responsibility. The challenge to achievability will be prioritisation. The FMA will need to robustly prioritise its workload, setting aside discretionary work and focusing on the most important of its core mandate.

Value for money – balance of benefit, cost and risk

Value for money in Option 2 is difficult to determine. On the one hand, it provides a relatively inexpensive approach to meeting the legal requirements of financial regulation in New Zealand. On the other hand, it will lead to large risks in financial markets, to an unknown extent for unknown firms and people. A full value-for-money assessment would take both of these effects into account. However, since the increased risk has not been quantified, it is difficult to assess the total impact. The value for money will become clearer only ex post – after some time has passed and the full risks are apparent, as is the case following the Australian Royal Commission.

Summary

Option 2 is a minimal approach to financial regulation, especially given the growth in remit and expectations. The impact will be to increase risk and harm, across all parts of the market and particularly for non-expert investors. While we recognise the lower cost of Option 2 (compared to Options 3 and 4), we do not recommend this option.

Option 3: Base

Overview

Over and above current spend (ie Option 2), Option 3:

- addresses the Government's expectations in the key areas of the new financial advice regime
- provides a small additional amount of resource to undertake follow-up to the conduct and culture reviews¹⁹
- broadens and deepens further the FMA's regulatory roles and, in so doing, reduces the risk of regulatory failure
- positions the FMA so that it is better placed to anticipate and respond to changes in financial markets (eg the impact of technology including automation) and is better able to absorb additional demands without significant disruption to existing workload
- addresses a range of pressure points including the need for regulatory action in a range of areas that have been put on hold as a result of resources being directed to the conduct and culture review
- includes a modest investment in corporate support and infrastructure consistent with the growing size of the organisation.

The financial implications are summarised in the table below.

Operating funding \$m	FY21	FY22	FY23	FY24
Additional funding for Option 2	7.673	8.073	10.020	11.098
Incremental funding for Option 3	5.805	10.308	10.242	10.503
Total additional funding needed for Option 3	13.478	18.381	20.262	21.601

Capital funding \$m	FY21	FY22	FY23	FY24
Funding for Option 2	3.300	-	-	-
Incremental funding for Option 3	0.00	-	-	-
Total funding needed for Option 3	3.300	-	-	-

It should be noted that the operating numbers above are net of other revenue (primarily licensing fee income) received by the FMA. The capital requirement is indicative only at this stage.

What Option 3 funds

The amount of funding needed, over and above Option 2, is summarised below.

¹⁹ It is important to note that the recently announced conduct regime for banks, insurers and non-bank deposit takers is not within the scope of this review. The additional FTE staff enable follow-up to the C&C review but they do not provide the level of resource that is expected to be needed for the FMA's remit (once scoped) under the new regime.

Additional operating funding over and above Option 2 (\$m)*	FY21	FY22	FY23	FY24
<i>Personnel costs by function</i>				
Supervision	0.493	1.452	1.417	1.458
Intelligence and knowledge management	0.161	0.436	0.427	0.439
Enforcement and investigations	0.463	1.020	1.008	1.036
Policy, governance and legal	0.321	0.579	0.557	0.573
Capital markets	0.321	0.579	0.557	0.573
Strategy and stakeholder relations	0.153	0.292	0.289	0.297
External communications and investor capability	0.157	0.437	0.432	0.444
Financial advice regime	1.179	1.904	1.918	1.969
Conduct and culture	0.593	0.584	0.582	0.598
People and capability	0.156	0.291	0.284	0.292
Operations	0.171	0.287	0.265	0.273
CE/Risk/Internal Audit	0.008	-0.002	-0.010	-0.010
<i>Other costs</i>				
Professional services	0.758	0.965	1.009	1.024
Organisational support and infrastructure expenses (occupancy, IT, depreciation, supplies, travel)	0.871	1.484	1.507	1.536
Total	5.805	10.308	10.242	10.503

* Numbers may not add precisely owing to rounding

The table below indicates the additional FTE staff required for each activity over and above Option 2.

Additional FTE staff over and above Option 2	FY21	FY22	FY23	FY24
Supervision	3	10	10	10
Intelligence and knowledge management	1	3	3	3
Enforcement and investigations	3	7	7	7
Policy, governance and legal	2	4	4	4
Capital markets	2	4	4	4
Strategy and stakeholder relations	1	2	2	2
External communications and investor capability	1	3	3	3
Financial advice regime	8	13	13	13
Conduct and culture	4	4	4	4
People and capability	1	2	2	2
Operations	1	2	2	2
CE/Risk/Internal Audit	0	0	0	0
Total	27	54	54	54

Compared to Option 2, the number of FTE staff increases by 54 (making a total FTE staff of 265).

Supervision

Option 3 funds a further 10 FTE supervision staff over and above the current spend option. Although the absolute number is not large, proportionately this is an increase of over 20% which enables the FMA to both broaden and deepen its approach to supervision.

This option enables the FMA to move to more of a portfolio-based supervision approach, and to shift the balance toward pro-active intervention rather than reacting to problems coming to the FMA's attention. Under this approach, supervision involves a combination of:

- using risk assessment to identify areas of poor conduct as well as to identify high risk businesses
- thematic reviews which enable the FMA to touch a lot of businesses in a cost effective way with the aim of identifying common and systemic issues
- using the findings from thematic reviews to inform the development of guidelines which, once produced, also enable the FMA to influence large numbers of firms in a cost-effective way
- assigning personnel to work more intensively with firms that are viewed as being high risk (and high impact if things go wrong).

This last aspect of the approach is the most resource intensive because of the need to engage directly and intensively with high risk firms because it is through engagement that influence (to change behaviours) is won. More generally, it also reflects the challenge of a principles-based approach to conduct regulation. A principles-based approach gives the law flexibility to deal with a wide range of conduct, business models and technology. It also requires, however, a proactive regulator that engages with industry, sets clear expectations and holds institutions to account.²⁰

The effectiveness of supervision-based regulation also depends on being able to cast a wide regulatory shadow. If firms think they are unlikely to appear on the radar of the regulator, they are less likely to be motivated to adopt good conduct practices. Breadth of supervisory coverage is, therefore, important. As noted on page 24, there are several areas where supervision effort of the FMA's existing licensed population has been less than that desired in recent times. In large part this reflects the flow-on impact of supervision resources being redirected to work on the C&C reviews in the first half of FY19.

Examples of activities associated with the monitoring function that have been deferred, but will be a priority for FY21 include:

- a sector risk assessment of Discretionary Investment Management Services (DIMS)
- monitoring of custodians (which had been deferred pending completion of the Custodian Exploratory thematic review which of itself had been deferred owing to C&C commitments)
- monitoring of Managed Investment Scheme (MIS) managers (which was deferred because of an earlier deferral of the MIS sector risk assessment).

Restoring previous levels of monitoring of AML/CFT reporting entities will also be a priority reflecting growth in the number of reporting entities. Similarly, additional resource will be directed to monitoring of financial advisers in light of the new regime and the greater number of licensed entities the regime gives rise to.

The increase in supervision effort under Option 3 has flow-on impacts in terms of effort that is then required for development of guidelines, undertaking investigations (more things will come to the FMA's attention), and more enforcement activity. These implications are discussed further below. The effectiveness of the supervision function (and the additional resources allocated to it) depends, in part, on lifting FMA's intelligence capability which is discussed next.

²⁰ Ministry of Business, Innovation and Employment (April 2019), Conduct of Financial Institutions: Options paper, p27.

Intelligence and knowledge management

Option 3 provides for a well-developed intelligence function to allow pro-active supervision to be focused on areas where maturity levels are low and risks are elevated. Option 3 builds on the investment made under Option 2 by adding a further 3 FTE staff. This includes embedding digital tools which involves tailoring the tools so that they are fit-for-purpose in the FMA's context. It also involves changes to ways of working.

Much of the focus under Option 3 is directed to building intelligence in relation to the new financial advice regime. Although there are good grounds for suspecting that this sector is risky, not enough is known about the sector to know specifically where the risks lie in the new financial advice population. The additional intelligence resource, coupled with the significant increase in FTE staff for the new financial advice regime, will be directed to better understanding the nature and scope of risks.

More generally, the additional resource directed toward intelligence and knowledge management is a flow-on consequence of growth in other areas of activity. For example:

- the licensing process for the new FA regime (particularly full licensing and to a lesser extent transitional licensing), generates information that needs to be assessed with a view to identifying potential indicators of risk
- increased supervision effort generates more information that needs to be turned into intelligence
- more generally, as awareness of the FMA grows (eg on the back of the C&C reviews), more matters are likely to be drawn to the FMA's attention
- as FMA continues to strengthen its engagement with sectors and businesses, one benefit of this is enhanced understanding of financial markets and how they work which provides an important feedback loop to understanding where the risks are and the impact of the FMA's interventions.

Enforcement and investigations

Proportionately, enforcement and investigations receives a slightly greater boost in resources, under Option 3, compared to most other areas. There are several reasons for this.

- Credible deterrence of misconduct is one of five strategic priorities identified in the FMA's 2019 sector risk profile.
- As part of general regulatory strategy, as regulatory regimes mature it is common to experience a shift in balance of regulatory effort toward enforcement with somewhat less effort (proportionately) directed toward other intervention including engagement and education. The reason for this is that in mature regulatory regimes, regulated parties are expected to know and understand their regulatory obligations; non-compliance becomes increasingly less tolerated. In regulatory terms, the regulatory regimes that are administered by the FMA (leaving aside the areas of new remit) are heading toward a more mature state where enforcement would expect to be a more utilised part of the regulator's tool-kit.
- In similar vein, in mature regimes, those who do not comply with their regulatory obligations tend to comprise businesses and individuals who have little or no intention of complying. Enforcement and the deterrence effect this creates generally is needed in such situations. A good example of this is the move to greater enforcement in the AML/CFT sector.
- Stakeholder research indicates that a lesser proportion of stakeholders (61%) consider the FMA maintains a strong enforcement function than those who consider FMA supports market integrity (88%) and raise standards of market conduct (84%). Although this could be interpreted several ways, one interpretation is that stakeholders consider enforcement is under-played relative to other types of intervention.
- Related to the last point, there are signs that the public expects the FMA to take increasingly strong actions to hold to account all "bad actors" and not just the "worst actors".
- Increases in supervision activity, and general awareness of the FMA and its role is likely to spur more matters coming to the FMA's attention some of which can be expected to flow through to more investigation and enforcement activity.

The additional resource enables the FMA to maintain a credible deterrence approach to enforcement by providing the capacity to respond to misconduct reports, investigate alleged breaches and take action in a timely manner.

Policy, governance and corporate legal

The Base option involves adding a further four FTE staff over and above the current spend option. Broadly speaking, the additional resource in these areas is a function of increased regulatory activity in other parts of the FMA plus contribution to law reform.

The additional resource under the Base option better addresses pressure points than is the case under the Current Spend option and reflects growth in regulatory activity generally under Option 3. The additional regulatory activity, particularly investigations and enforcement increases the need for legal input (eg in context of taking legal action to hold to account those who breach regulatory requirements).

Demand for input to law reform generally exceeds the FMA's capacity to contribute. The additional resource seeks to achieve a better balance between demand and supply.

Capital markets

Option 3 adds a further four FTE staff to the Capital Market's team over and above the Current Spend option.

A reasonable proportion of work in the capital markets area is demand driven; for example, market misconduct investigations or work in relation to initial public offerings (IPOs). Equally, a reasonable proportion of workload is also discretionary in the sense that the level of effort can be scaled up or down.

The additional funding and resource under Option 3 would enable the capital markets team to scale up activity in several areas:

- more analysis of unstructured public data
- work on algorithmic trading
- more engagement with market participants
- wider spread of review work leading to issuing more guidance (eg KiwiSaver disclosures and fees)
- more work on emerging markets (eg peer-to-peer lending and crowdfunding).

One area that is not discretionary and, generally, is not scalable is audit oversight. Current capacity is at the minimum viable level. Option 3 enables the FMA to step above the bare minimum.

More generally, Option 3 provides a degree of surge capacity. The FMA estimate that the work on the C&C reviews consumed up to 20% of the capacity of the capital markets team. This caused work to be deferred or delayed in a number of areas. Option 2 helps to address this situation but it doesn't provide capacity to deal with unexpected/unplanned issues. In contrast, Option 3 provides more capacity and, accordingly, provides the ability to respond to the unexpected without causing major disruption to other workstreams as a result of diverting resources away from their normal roles.

Strategy and stakeholder relations

Under Option 3, a further two FTE staff are added to the strategy and stakeholder relations team over and above the current spend option (which has 6 FTE staff in the team).

One of the main functions performed by this team is leading the strategic risk outlook process. PESTLE analysis is performed to assist with understanding trends and developments in the sectors and markets that are regulated by the FMA. With expansion of the FMA's remit, there is more to look for and analyse.

As part of the additional resource that is sought under Option 3, there is the opportunity to broaden the scope of disciplines that are used to assess trends and developments and, at a strategic level, think about the regulatory response. In particular, under Option 3 there is scope to appoint a behavioural economist (or similar). This type of discipline is, in our experience, an increasingly common feature of a regulator's capability.

Other drivers of the need for additional resource in this area mirror those across other parts of the FMA. Examples of this include:

- requests for input to policy development and reform (to which the strategy team is a contributor)
- broadening of the FMA's remit which means a wider spread of stakeholders who need to be engaged as well as a wider spread of regulatory issues to engage over.

External communications and investor capability

Option 3 adds a further three FTE staff over and above the current spend option. The focus is on building investor capability while recognising the need to integrate with roles performed by other agencies including the Commission for Financial Capability (CFFC).

The existing team comprises 10 FTE staff and broadly speaking, the size of team appears to be about right for the current size of the overall organisation and its current remit. However, under Option 3, the overall size of the organisation increases and the remit is expanding firstly in terms of the new financial advice regime and, in the near term, the new conduct remit. If only for these reasons, there is a need to scale up the capacity of the external communications and investor capability team.

In addition, however, there are other drivers that lie behind the need for additional resource.

- Historically, FMA's core target audience was people aged over 50 with money to invest. However, survey demographics and analytics from communication with investors point to the need to widen this target audience. For example, KiwiSaver, among other developments, is broadening the base of investors. Younger investors are an increasingly important audience (and they are using different products).
- There is a need to give more tailored focus to the more vulnerable members of society. There is also a need to be responsive to the growing diversity within NZ society. The approach to communication and capability for NZ Pākehā does not automatically work well for other ethnicities.
- In terms of the approach to communication, there is growing need to make changes to communications style as well as channels. The FMA has already had to host some webpages externally because they did not work on the FMA's main website. Digital channels (eg Facebook groups) are an area of under-utilisation for the FMA which is currently engaging in only a limited fashion on these channels reflecting the demographic composition of the stakeholders that the FMA has traditionally focused on (but which is now broadening). Further utilisation of these channels to reach a wider audience would require additional capability.

More generally, the level of investor knowledge is low. Building investor capability (and confidence) is one of the Government's specific expectations of the FMA and this links directly to the FMA's own strategic priority concerning investor and customer decision making. External communications and investor capability has a role to play in addressing this while recognising this is not the complete solution.

Financial advice regime

Compared to Option 2, the additional resource that is directed to the FA regime under Option 3 will enable the FMA to take a more informed and risk-based approach to supervising this sector. The sector is expected to undergo significant change. An estimated 80% of existing financial advisers are sole operators or are part of firms with five or fewer personnel. The FMA anticipates consolidation. Moreover, many RFAs are nearing the end of their careers (an estimated 800 RFAs are aged 70 or more) and/or do not possess the qualifications that are needed under the new regime. Accordingly, the new regime may be a trigger for these advisers to exit the market. Over and above these considerations, the increased regulatory scrutiny under the new regime may prompt some advisers to "fly under the radar" as a way of trying to avoid regulatory scrutiny.

All of these factors contribute to a picture of significant change and risk. The challenge for the FMA is that, particularly for the ex-RFAs, little is known about the providers. Accordingly, the additional resource that is sought under Option 3 will enable the FMA to develop its understanding of how the market is changing, and the risks it poses, much faster than would be the case under Option 2. Building this understanding more swiftly will enable the FMA to get underway with some thematic reviews in areas where risks are suspected to be greatest. The thematic reviews are an efficient way of building a better understanding of the risks in the sector and, in

light of review findings, developing guidelines to help the sector understand what good conduct and practices look like. Developing a picture of the risk profile as soon as possible also means that the FMA can engage sooner in more targeted risk-based supervision of the sector.

Conduct and culture

In light of the findings from the C&C reviews, banks and life insurers have been required to provide the FMA with further information (action plans) detailing how they propose to address the conduct and culture issues identified in the review. This process is ongoing. For example, nine life insurers need to provide the FMA and RBNZ with updated systematic reviews by 20 December 2019 (due to inadequate responses). All life insurers need to provide the FMA and RBNZ with progress updates by 28 February 2020 and the second update by 31 August 2020. There is a need to test the progress updates in the sense of ascertaining the extent to which the intentions expressed in the action plans are being implemented in practice and in the sense of whether those plans are having the desired effect. The additional resource that is funded under Option 3 would, in an interim way, better enable the FMA to start this work. The work to date on the C&C reviews has given the FMA a lot of access to, and engagement with, the “C” suites of the banks and insurers. This has resulted in high levels of respect for the FMA and strengthened the FMA’s ability to influence conduct and culture within these institutions. The Base option enables the FMA to engage more with entities on policy and system improvements to support better identification, response and reporting of conduct risks and issues.

Option 3 provides for 13 FTE staff to continue work on the C&C review follow-up ahead of the proposed legislation (four more than the Current Spend option). To put this into context, and as noted earlier, at its peak the FMA had 31 staff diverted from their normal roles and responsibilities to work on the C&C reviews across banks and life insurers.

The additional resource sought under Option 3 allows for additional follow-up work (ie continuing the processes that are already in place) but it does not provide the resource that is needed for the new C&C regime (this is outside the scope of this review).

Organisational support and infrastructure

Under Option 3, a further four FTE staff are added in the corporate support area (two FTE staff for people and capability and two FTE staff across other core corporate functions (IT, finance and programme management)).

The additions in these areas are primarily a function of the larger size of the organisation under Option 3 compared to Option 2.

- Over the next two years there will need to be a substantial recruitment drive (under the Base option, FTE staff increase by 66). This is on top of normal recruitment arising from staff turnover. Staff retention is an ongoing challenge for the FMA given the high calibre of its staff and high demand for regulatory experience in the market.
- New staff require training in order to become effective regulators. The significant increase in recruitment numbers will place added pressure on learning and development, training and support.
- Option 3 involves a significant amount of change for the FMA. Clear internal communication to keep staff informed about the changes and the implications for them and the wider organisation is an important part of change management.
- The changes in organisational size and remit will spur a number of projects and these need to be managed effectively which places additional demands on programme management.
- Growth in staff numbers has knock-on effects for finance, people and capability, IT and accommodation; for example, more licences, more computers and more office space. Strengthening the intelligence function including data and analytics, is also likely to require investment in IT.

Phasing

Option 3 funds a significant increase in overall FTE staff. The labour market within which the FMA competes for high quality personnel is very competitive and is likely to become even more competitive as banks, insurers and other financial institutions respond to the need to lift standards of conduct.

Reflecting this, the FMA is acutely aware that recruitment and retention strategies will need to be well planned and managed. This includes being realistic as to the pace at which overall FTE staff numbers can increase.

Although the additional resources sought under Option 3 touch all parts of the FMA, there are some areas where need is greatest and these areas will be targeted as high priority for recruitment. Two areas in particular are identified as a top priority for a scaling up of resources.

- Managing the new FA regime is a top priority. The transitional licensing period opened in late November 2019 and the window for full licensing applications will open on 29 June 2020. The market is expected to be very fluid which increases the need for the FMA to closely monitor and assess developments and their implications for risk. A total of 25 FTE are anticipated for this function of which the aim is to have 20 of these in place by the end of FY21.
- Follow-up to the C&C reviews is another high priority. Work to date has given FMA considerable influence across the conduct and culture at banks and insurers. Now is the time to leverage that and respond to the heightened public (and government) expectations that the regulator will take further action. A further 4 FTE (over and above the current spend option) are to be added to the C&C review follow-up and the aim is to appoint all in FY21.

The budget for FY20 assumes 199 FTE staff. By the end of FY21, FTE staff will increase to 238 and by the end of FY 22, FTE staff will number 265. This flows through into baseline funding as shown below.

Over and above Option 2:	FY21	FY22	FY23	FY24
Additional FTE staff	27	54	54	54
Additional funding (\$m)	5.805	10.308	10.242	10.503

Assessment

Reasonably good alignment with Government's expectations and FMA's strategic priorities.

The level of resource assigned to the new FA regime will enable good progress to be made with understanding the FA market and risks posed. Compared to Option 2, this option will enable the FMA to adopt a more proactive, and relatively swift, approach to implementing the regime. The additional resources available under Option 3 means that the FMA is able to establish a pro-active cycle of monitoring financial advisers as well as make early progress with thematic reviews.

Some additional resource is directed to follow-up to the recent C&C reviews. Momentum is maintained although Option 3 limits the FMA to a mostly tactical, rather than strategic, approach to the follow-up; that is, the FMA is able to engage with individual banks and insurers with a view to ensuring that their action plans address areas of concern and that those plans are having real effect. However, there is not enough resource under Option 3 to take a more strategic response; for example, standing back to identify and assess the systemic issues arising from the action plans and what this means for future regulatory intervention.

Option 3 enables more investigation and enforcement activity. As regulatory regimes mature, it is normal to expect an increase in enforcement activity to deal with those who persistently fail to comply with their regulatory obligations.

However, Option 3 does not enable as much as a shift to a customer focus (compared to Option 4) and, to this extent, does not fully align with the Government's expectations and one of FMA's strategic priorities.

Strengthened regulatory effectiveness.

The additional resources that are funded under Option 3 enable the FMA to increase the breadth and intensity of supervision and monitoring, enforcement activity and market engagement activity to respond to the lack of conduct maturity identified across financial markets.

Additional resources enable the FMA to adopt a more portfolio-based approach to supervision. This approach promotes a more proactive approach to regulatory intervention. It involves more thematic reviews (which enable the FMA to touch a lot of businesses in a cost-effective way and to inform the development of guidelines) as well as assigning personnel to work intensively with businesses that are viewed as being high risk (and high impact if things go wrong). The portfolio approach helps with casting a wide regulatory shadow thereby sending a clear signal to market participants that if they breach their regulatory responsibilities, they are likely to be found out and held to account.

The additional resources directed to investigation and enforcement also assist in this regard and this helps to ensure there is an effective and credible deterrent effect.

Modifying the behaviours of market participants is resource intensive because to be effective, it requires a lot of engagement. Option 3 provides for more engagement with entities on conduct policy and systems and improvements to support better identification of, response to, and rectification of conduct issues. In this respect, Option 3 promotes a more pro-active regulatory stance aimed at avoiding issues arising in the first place (rather than reacting to them after they have occurred).

Resource is directed to strengthening the intelligence function. This is highly desirable because it helps with understanding where risks and harms are greatest and ensuring an appropriate regulatory response. The function is strengthened by the addition of more personnel, new capabilities (which we consider should include a behavioural economist) and embedding digital tools.

Addresses current pressures and provides resilience

The additional resource under Option 3 is used, in part, to address a range of issues that have been on the back-burner because of the C&C reviews. Examples include AML supervision, investor capability and capital markets monitoring.

Option 3 provides some surge capacity (better resilience). In this regard, it better future-proofs the FMA than is possible under Option 2. For example, the additional resource places the FMA in a better position to address known future developments as well as unexpected market events without significantly undermining base levels of activity.

Reduced risk – regulatory failure and reputational

All of the above features of Option 3 contribute to the ability to identify and deal with risks and harms sooner than would be the case with Option 2. The FMA's understanding of the drivers of risk would be improved, thereby enabling early mitigation, swift response and the right regulatory response. Put another way, this means regulatory failure and reputational risk is reduced. Investors should have more confidence in markets and are at less risk of harm.

Value for money

Option 3 is likely to deliver significant benefits (albeit these can't be quantified) over and above costs as a result of being better positioned to (among other things):

- move more quickly to understand, and address, the risks among providers under the FA regime
- address a range of pressure points
- step up enforcement activity
- make more of a move to a portfolio-based approach to supervision
- target effort and tailor regulatory response based on more robust intelligence and knowledge management.

Achievability

Option 3 involves a substantial increase in funding a lot of which is directed toward recruiting new personnel. Overall, under Option 3, there are up to 66 FTE staff added to the FMA's payroll. That is a substantial number. Reflecting this, the success of Option 3 rests heavily on the ability to attract and retain a significant number of high calibre personnel.

The FMA is well aware of this challenge and this is reflected in a phased approach to the implementation of Option 3 (noting that the duration of the phasing could be modified). The success of Option 3 will also rest on good change management and planning.

In this regard, we note the following points.

- This is not a new challenge. The FMA has grown significantly since its establishment in 2011. In 2014 the FMA began working under a much wider mandate than its predecessor organisation, with the introduction of the FMC Act 2013. Since 2014, staff numbers (measured in headcount terms and excluding contractors and temporary personnel) have increased by 52%.
- The FMA has also successfully increased recruitment numbers in response to the combination of spikes in turnover and underlying growth in the demands being placed on the organisation. For example, in the year ending June 2019, FMA successfully recruited 67 personnel from outside of the organisation.
- The level of turnover has recently reduced from June 2019 levels.

Moreover, the FMA has several initiatives in train that position it for large-scale recruitment. These include:

- reaching into international markets (on the assumption it is unlikely that all positions can be filled from domestic candidates)
- procuring support from a range of suppliers of recruitment and related services (including entities with proven experience in recruiting from international markets)
- engaging with relevant Government agencies (NZTE and Immigration NZ in particular) to assist with networking in source countries as well as providing hosting opportunities for events at which FMA can have physical presence
- reviewing the approach to market in terms of the types of media and channels used to raise awareness of employment opportunities with the FMA
- refreshing its employee value proposition to ensure it remains as relevant as possible.

In addition to recruiting permanent staff, the FMA is also keeping open other options including use of contractors, secondments and shared resources with other regulators and enforcement agencies.

Summary

Option 3 has a lot to offer because it:

- aligns reasonably well with the Government's expectations
- makes a good contribution to FMA's strategic priorities
- addresses pressure points
- lifts organisational resilience although it does not provide the degree of future-proofing that is provided under Option 4 (see below)
- significantly reduces the risk of regulatory failure compared to Option 2
- delivers value for money (but not as much as Option 4 as discussed below).

The scale of the FMA increases by about a third when measured against the current number of FTE staff. That is a substantial increase and it will pose significant recruitment and other challenges notwithstanding that there will be a phased approach to scaling the organisation. Potentially, there may need to be some changes to the pace of transition.

Notwithstanding the benefits that stem from Option 3, and the challenges posed by increasing the size of the FMA, we stop short of recommending Option 3 as the preferred option. In our view, Option 4 has the potential to deliver even more impact and it is this option to which we now turn.

Option 4: Enhanced

Overview

Over and above Option 3, this option enables the FMA to further broaden and deepen activity across the spectrum of regulatory interventions. This includes additional resource for the new financial advice regime which will enable the FMA to develop a richer understanding of the market and its risks sooner than would otherwise be the case.

Importantly, however, and as a major point of difference from Option 3 (and Option 2), Option 4 involves a material change in the nature of the FMA's work. In particular, it:

- enables a shift to a much stronger systems focus in its work including supporting greater financial market system coordination and engagement
- enables a shift to a greater focus on customers over and above the existing focus on investors including more work on good customer outcomes, conduct guidance and oversight of remediation activities
- provides the FMA with some (minimal) additional resource to plan and prepare for its new conduct and culture remit
- supports a significant focus on capability building and building the FMA's maturity as a regulator.

In our view, these additional features are highly desirable and address more of the key challenges and opportunities identified in the efficiency and effectiveness review. Notwithstanding that Option 4 will pose even more of a challenge (because of the extra scale involved over and above Option 3), it is a challenge that is worth taking on. In our view, the earlier it is possible for the FMA to get certainty as to whether Option 4 is likely to be funded, the sooner the FMA can commence the planning that will be needed for what will amount to a significant change programme. In turn, the better the planning, the more likely is the achievability of Option 4.

The financial implications are summarised in the table below (and the figures are net of other revenue).

Operating funding \$m	FY21	FY22	FY23	FY24
Additional funding for Option 2	7.673	8.073	10.020	11.098
Incremental funding for Option 3	5.805	10.308	10.242	10.503
Total additional funding needed for Option 3	13.478	18.381	20.262	21.601
Incremental funding for Option 4	1.686	4.693	4.742	4.739
Total additional funding needed for Option 4	15.164	23.074	25.004	26.340

Capital funding \$m	FY21	FY22	FY23	FY24
Funding for Option 2	3.300	-	-	-
Incremental funding for Option 3	-	-	-	-
Total funding needed for Option 3	3.300	-	-	-
Incremental funding for Option 4	0.500	-	-	-
Total funding needed for Option 4	3.800	-	-	-

What Option 4 funds

The amount of funding needed, over and above Option 3, is summarised below.

Additional operating funding over and above Option 3 (\$m)*	FY21	FY22	FY23	FY24
Personnel cost by function				
Supervision	0.196	0.716	0.722	0.732
Intelligence and knowledge management	0.054	0.224	0.225	0.229
Enforcement and investigations	0.100	0.589	0.595	0.606
Policy, governance and legal	0.257	0.438	0.442	0.449
Capital markets	0.108	0.287	0.289	0.292
Strategy and stakeholder relations	0.027	0.187	0.189	0.193
External communications and investor capability	0.042	0.361	0.365	0.373
Financial advice regime	0.077	0.416	0.419	0.427
Conduct and culture	0.349	0.361	0.365	0.373
People and capability	0.038	0.201	0.203	0.207
Operations	0.238	0.411	0.415	0.422
CE/Risk/Internal Audit	0.027	0.032	0.032	0.031
Other costs				
Professional services	0.016	0.085	0.087	0.083
Organisational support and infrastructure expenses (occupancy, IT, depreciation, supplies, travel)	0.158	0.385	0.393	0.323
Total	1.686	4.693	4.742	4.739

* Numbers may not add precisely owing to rounding

The table below indicates the additional FTE staff required for each activity over and above Option 3.

Additional FTE staff over and above Option 3	FY21	FY22	FY23	FY24
Supervision	0	3	3	3
Intelligence and knowledge management	0	1	1	1
Enforcement and investigations	0	3	3	3
Policy, governance and legal	1	2	2	2
Capital markets	0	1	1	1
Strategy and stakeholder relations	0	1	1	1
External communications and investor capability	0	2	2	2
Financial advice regime	0	2	2	2
Conduct and culture	2	2	2	2
People and capability	0	1	1	1
Operations	1	2	2	2
CE/Risk/Internal Audit	0	0	0	0
Total	4	20	20	20

Compared to Option 3, and by FY 22, the number of FTE staff increases by a further 20 (making a total FTE staff of 285).

Although the allocation of the additional resources under Option 4 is broadly based, compared to the other options, Option 4 does confer some important differences, which are described next.

Systems focus

The FMA is a lead, but not the only, regulator of financial markets. The wider regulatory system also includes the RBNZ, Commerce Commission, Serious Fraud Office, MBIE, Police, and front-line regulators among others. Option 4 supports taking more of a systems perspective to the work of the FMA and how this fits with the wider regulatory system. This includes supporting greater financial market system coordination and engagement. It involves taking a systems view of issues and how to tackle them. This includes cross-agency system engagement on issues of common interest as well as strengthening existing cross-agency initiatives including the CoFR.

Option 4 enables a shift to looking at regulatory intervention through the lens of the system as a whole rather than just through the lens of the individual regulator (eg by investing more resource in CoFR work programmes). The efficiency and effectiveness part of this report described the work that is already under way to create a more joined-up approach to financial markets regulation, but also noted that the work is somewhat discretionary and subject to the priorities of leadership at the time. Option 4 moves further toward embedding and institutionalising an approach to regulation that puts relationships with other regulators at the centre of the work, rather than the periphery.

Customer focus

The traditional focus of the FMA has been on investors. The C&C reviews have spurred the beginnings of a shift to also thinking about harms and regulatory issues through a customer lens. Insurance is a good example of this where it is customers, rather than investors, who have incurred harm as a result of poor conduct by providers and their intermediaries.

Option 4 builds on the shift toward customer-oriented thinking. The Enhanced option funds capability to undertake work on what good customer outcomes look like, what sort of conduct is needed to support achievement of these outcomes and research into the issues and concerns that are uppermost for customers. This includes a greater focus on behavioural drivers. All of this flows into development of policy, guidance and supervision practices designed with a customer (and investor) lens.

Option 4 strengthens further the FMA's behavioural insights capability. This will enable more work with providers on how they design campaigns and processes to reach customers/investors. It also allows the FMA to undertake more research to better understand customers and their actions, and what influences customers' behaviour. In short, this will result in communications and processes that are better targeted at, and designed for, particular demographics and that cater to the specific needs for vulnerable consumers. In the context of C&C, and more generally, Option 4 provides more resource to focus on key issues, such as remediation, that have direct benefit for customers.

Option 4 also provides further resource throughout the organisation to increase the focus on communications, especially with digital channels and a diverse range of customers in mind. The efficiency and effectiveness review noted that the use of social media, such as Facebook, was an area of opportunity. The FMA has identified mass social media platforms as a potential channel for achieving better impact. Option 4 provides more resource (over and above Option 3) to implement improvements. Combined with the work on behavioural insights and behavioural economics, some of which is provided for under in Option 3 and more is provided under Option 4, the increased focus on communications has the potential to improve outcomes for a broad section of New Zealanders.

Financial advice regime

At this stage, there is quite a lot of uncertainty regarding how the new FA regime will play out, and what risks the changes will give rise to. The additional resource that is provided for under Option 4 provides for a step up in the implementation and supervision of the new FA regime. What this means is the ability to:

- develop a richer picture of how the market is developing, and the risks posed, sooner than would be the case under Option 3 which enables sector risk profiles and guidance to be developed sooner than would otherwise be the case and for engagement to be better targeted
- have a cycle of proactive monitoring that involves scrutiny of most high risk entities once every two or three years, rather than four or five years under Option 3 (subject to the caveat that it is hard to be definitive on this until more is known about the number of entities and their risk profiles)
- tilt the balance of monitoring to have a higher weighting toward on-site activity over and above desk-based analysis
- undertake highly targeted thematic monitoring driven by findings and trends from individual monitoring and other sources of intelligence.

Preparation for new conduct remit in banking and insurance

The new conduct remit is expected to be a significant addition to the FMA's existing roles and responsibilities. There is a lot that needs to be worked through to position the FMA for the new conduct remit. For example, the new remit is likely to spur a need for changes to the FMA's operating model including systems, processes, operating policies, organisational structure and other elements of operating model. The new remit will also require much greater engagement and coordination with other financial markets regulators. In short, the new remit will involve a major change programme.

The additional resource that is provided under Option 4 enables the FMA to make a start with the planning and preparation needed for the change programme but it does not, of itself, fund that change programme. Moreover, the resource under Option 4 does not provide for the resource that will be needed to administer to new remit. The resources that will be needed to execute the change programme and administer the new remit will be the subject of further consideration beyond the scope and timing of this Review.

In addition to making a small "down-payment" on the work that will need to be taken ahead of the new remit coming into effect, Option 4 also provides some additional resource for the follow-up work to the C&C reviews. The additional resource enables the FMA to take a more strategic view of the systemic issues in the banking and insurance sectors drawing on the scope and quality of the plans and other responses that banks and insurers will continue to provide to the FMA.

We note that the FMA has been conducting similar preparatory work in advance of the start of the FA regime. That work has been funded by re-allocating budget from other activities, and has been prioritised because the FMA determined, through its strategic processes, that getting ahead of the financial advice regime was important for its success. Given that experience, it seems sensible to fund preparation for the new conduct remit explicitly.

Building capacity and strengthening capability

The Enhanced option enables a significant focus on capability building and building the FMA's maturity as a regulator. This involves strengthening further its regulatory functions generally, as well as investing further in organisational support and infrastructure.

In terms of regulatory functions, the extra capacity and capability better enables the FMA to extend further its focus into new areas and issues such as the implications of climate change concerns, technological developments and innovation in financial markets more generally. It allows for more thematic reviews and more deep dives into areas and businesses where problems are identified. It further strengthens the intelligence function which, in turn, contributes to a better understanding of risk and targeting of regulatory effort. The larger scale of the organisation allows for more specialisation by sector/industry within the teams involved with monitoring, market analysis and engagement (while, at the same time, maintaining the ability to work across

multiple sectors). The ability to specialise helps to build even deeper understanding of the sectors, industries, and/or firms that are in focus.

The increased size of the organisation has a natural flow-on impact in terms of the need to also build the corporate centre to ensure that it is capable of providing the corporate support and infrastructure needed to maintain the efficient functioning of the organisation. In particular, our assessment of efficiency and effectiveness discussed the work to embed new knowledge and information management behaviours into the organisation, noting that there are issues with staff trust in existing systems and development of work-arounds. To function as a more integrated organisation using modern tools, the FMA requires funding and time to invest in staff. Option 4 provides more of those resources than the other options.

Capital funding

A small amount (\$0.500m) is sought for capital funding in FY21. This is for the possible establishment and fit-out of a new Christchurch office.

The increase in the size of the FMA under Option 4 (up to 285 FTE staff) spurs renewed consideration of the option to establish a presence in New Zealand's second largest city. From a regulatory presence and footprint perspective, there are advantages in having a South Island office and Christchurch is the obvious location in this regard. The need to recruit large numbers of additional staff means that it would also be logical to think of Christchurch as a potential labour market from which to attract recruits.

Assessment

We consider that Option 4 has advantages and delivers net benefits over and above Option 3. Our reasons for this are as follows.

Strategic fit – contribution to investment objectives, meeting business need and integrating with other strategies, programmes and projects

Option 4 does an even better job than does Option 3 of responding to Government's expectations particularly in relation to the new FA regime and the follow-up to the C&C reviews (and positioning for the new conduct regime).

The new FA regime is a key part of a suite of measures aimed at better protecting consumers. Financial advisers touch the lives of a significant proportion of new Zealanders. The quality of advice the advisers provide can make a huge difference in people's financial position and the quality of life they are able to enjoy. New Zealanders need to be confident that those who give them advice on their finances are skilled and subject to effective regulation supporting good practice. The challenge is the large number of advisers, a large proportion of whom have not been subject to regulatory scrutiny, and significant uncertainty as to how the market will evolve.

In our view, this emphasises the need for the regulator to direct as much resource and effort as possible to understanding the market and the underlying "threatscape" as soon as possible so that decisions can be taken as early as possible regarding the nature and scope of the appropriate regulatory interventions (ie thematic reviews, on-site monitoring, development of guidelines and so on). Option 4 delivers more speed in this regard than does Option 3 which means more confidence that the objectives underlying the new regime are achieved and less risk of major regulatory problems emerging.

Option 4 also provides more support for the follow-up to the C&C reviews. This is another area which we consider warrants as much resource as is feasible. The work on the C&C reviews has created an environment within which the FMA has influence at the "C" suite level within most of the entities that have been a focus in the C&C reviews. Now is the time to leverage that influence and work with the banks and insurers to ensure that their plans and responses are appropriate and that, moreover, they execute those plans and deliver to the undertakings given.

Systems approach

We are very supportive of the system approach that is a feature of Option 4. Leveraging the insights across regulators, as part of a systems approach, almost certainly will deliver a richer understanding of how markets work and the risks and harms posed as well as how best to address these. A more joined-up approach across regulators is likely to benefit businesses. They will find it easier to engage with regulators, and understand what they need to do to meet the regulators' expectations if there is greater consistency of approach and understanding of markets across those regulators.

We also note that a systems approach, by reducing regulatory burden and increasing clarity, has the potential to increase activity in financial markets, particularly by stimulating offerings from smaller and newer participants. As noted in the efficiency and effectiveness assessment, the FMA has the remit to support development of financial and capital markets but this is an area that would benefit from more attention. Strengthening the systems approach is a specific and visible activity that the FMA can undertake to demonstrate its commitment to this objective.

Capability building, resilience and future proofing

The larger size of the FMA under Option 4 confers several benefits. It provides the FMA with the ability to cast a wider regulatory shadow generally and not just in respect of financial advisers (as discussed above). It also provides the FMA with more ability to respond to unexpected issues when they arise (eg significant market events like the liquidation of CBL Insurance Ltd) without having to divert resources to an extent that then comprises other activity causing problems elsewhere. More generally, Option 4 will help to increase the speed, breadth and depth of regulatory activity to bring about desired behaviours.

The further investment in intelligence and analytical capabilities will allow more research and analysis to better understand the markets the FMA regulates and the investors and customers they serve. The increased focus on knowledge and information management addresses one of the key concerns arising from our assessment of efficiency and effectiveness. It also provides tools for future-proofing the FMA as financial products and online activities change and grow.

Achievability – eg implications for change management, operating model, timing/phasing

Like Option 3, the most significant challenge associated with Option 4 is the need to recruit a large number of new employees. Option 4 involves up to 20 additional FTE staff over and above Option 3.

Option 4 provides further capacity and capability to support the FMA in the significant organisational change required including changes to operating model and structure. Reflecting this, and taking into account the initiatives discussed under Option 3 that the FMA has underway in relation to recruitment, we consider that Option 4, like Option 3, is likely to play out as requiring a longer time frame to achieve the required number of additional staff, rather than a higher risk that the higher number will not be achieved.

Risks – regulatory failure, reputation

Option 4 is the best option for reducing the risk of regulatory failure. It takes the most comprehensive approach to the sectors being regulated and a system perspective toward regulators. It provides the best opportunity for the FMA to have a robust view on the risks arising from the regulated sectors and changes to regulation, including changes in the financial advice sector. It also reduces the risk of overly burdensome regulation or gaps that can arise from poorly joined-up regulation across government. Finally, it provides the resources for the FMA to be a credible regulator in the market and maintain surge capacity to deal with unforeseen, difficult issues.

These improvements do not mean zero risk in financial and capital markets. Instead, they will allow the FMA to match its activities with understood risks of harm. They will also permit the FMA to put more focus on its role in developing capital markets, but with full understanding of the risks involved.

Impact from the market's perspective (what they get/do not get)

From the market's perspective, Option 4 is superior to Option 3 because of the focus on better intelligence and understanding of market participants and the impacts of regulation on the market. As described above, Option 3 provides a regulator that can handle the full remit of the FMA and has a full toolbox for its regulatory, investigatory and enforcement activities. Option 4 adds more robust and nuanced understanding of regulated

firms and sectors, their impacts on the economy and their behaviour with respect to the regulatory system. Option 4 also adds more information management capability and a more systems focus, which has the potential to reduce the compliance burden for the market. Finally, Option 4 simply adds more capacity, which should increase the speed of the FMA in dealing with regulated entities. In short, Option 4 is about producing a better regulator for markets.

Value for money – balance of benefit, cost and risk

Option 4 delivers more value for money over and above Option 3. The increase in funding is small relative to the total additional funding for Option 2 and Option 3, but it has the potential to unlock considerable benefit. The hurdle to getting the full benefit of investments in knowledge and information management to date has been affordability: the changes not just in software but in systems and behaviours have been too large for existing budgets. Option 4 cuts through those difficulties and sets up the FMA to get the most from the systems it is developing. In addition, the focus on understanding financial businesses and customers will give the FMA the tools and capability to support the development of financial and capital markets. Any gains New Zealand can make from FMA's support of economic activity through better financial markets will far outweigh the additional cost of Option 4.

Summary

Option 4 offers more, over and above Option 3, in terms of:

- providing a much stronger systems focus
- enabling a greater shift to a customer (as well as investor) focus
- better preparing the FMA for expansion of its remit (including regulating conduct in the bank and insurance sectors)
- lifting further the maturity of the regulator
- allowing more focus on working on, not just in, the regulator
- building expertise in both regulation and the sectors the FMA regulates
- optimising value-for-money.

For these reasons we consider Option 4 is the preferred option.

Baseline summary and conclusions

Context

The FMA's remit has expanded and will increase further. Accordingly, the demands being placed on the FMA are increasing. Moreover, expectations for the FMA to do more are increasing as reflected in the Minister's LoE. There are multiple pressure points across the spectrum of regulatory roles performed by the FMA. On top of this is ongoing cost pressures particularly in relation to market levels of remuneration. A change in baseline funding is required. Four baseline options have been considered.

Option 1

Option 1 (no more funding) is not viable and does not warrant further consideration. Under a "no more funding" option, a substantial reduction in personnel numbers (circa up to 40 FTE staff), and consequential cut in operating expenditure (circa \$5 million in FY21 and growing beyond that) would be required to close the FMA's operating deficit and enable deployment of resources to execute on the FMA's new regulatory functions in relation to the new FA regime and follow-up to the C&C reviews. The cut in operating expenditure is likely to have a substantial and adverse impact across all of the FMA's outputs; monitoring and supervision, investigation and enforcement, market analysis and guidance, investor awareness and regulatory engagement. This retraction is likely to have a detrimental effect on market confidence and the reputation of the New Zealand financial markets.

Option 2

Option 2 (current spend) is not a desirable, option. Option 2:

- has a medium level of strategic fit with the Government's expectations and the FMA's strategic priorities
- provides a bare minimum to enable the FMA to implement and administer the new financial advice regime, but monitoring activity would be primarily reactive with proactive monitoring directed to the highest risks only
- allows for only tactical follow-up on the conduct and culture review of banks and life insurers
- does not have good strategic alignment with the expectation that the FMA will shift toward an increased customer protection focus, on top of its existing investor focus
- does not provide sufficient resource to deal with all pressure points which means some areas of deferred activity may continue to be under-resourced (thematic reviews are a likely example) and other areas of pressure, if addressed will be replaced by new issues for which there is insufficient resource
- does not allow for increased investigation and enforcement activity (which, as noted in Part A of the report, is an activity that warrants increased activity)
- does not address concerns regarding the need for building capability and resilience and so does not future-proof the FMA
- increases the risk of regulatory failure from the current level because resources are stretched thinly and pressure points are not adequately addressed
- does not optimise value for money (ie benefits relative to costs) as more can be done that delivers significant benefits over and above the costs involved.

Option 3

Option 3 (base) is a good option but it is not optimal. It involves additional operating funding of up to \$21.6 million.

This option enables the FMA to be a more effective regulator than is possible under Option 2. It enables a more effective, and better resourced, inter-play between FMA's regulatory levers and roles; the effectiveness of the regulator rests, in part, on a well-rounded approach. Option 3 aligns with the FMA's strategic priorities and goes some way to meet Government's expectations.

There are other positive features associated with Option 3.

- The level of resource assigned to the new FA regime will enable the FMA to adopt a risk-based, and relatively swift, approach to implementing the regime.
- Some additional resource is directed for follow-up to the recent conduct and culture reviews, although for a mostly tactical, rather than strategic, approach (noting that assuming the FMA will be expected to play an ongoing role in regulating the conduct of banks and insurers, it will need to have sufficient funding).
- Option 3 enables more investigation and enforcement activity, in line with a maturing regulatory regime that is dealing with those who persistently fail to comply with their regulatory obligations.
- Resource is directed to strengthening the intelligence function. This is highly desirable because it helps with understanding where risks and harms are greatest and ensuring an appropriate regulatory response.
- The additional resource enables the FMA to adopt a more portfolio-based approach to supervision, as well as thematic reviews and intensive work with businesses that are viewed as being high risk.
- Option 3 includes some resource to address a range of issues that have been on the back burner because of the C&C reviews and some surge capacity for better organisational resilience.

All of the above features of Option 3 contribute to the ability to identify and deal with risks and harms sooner than would be the case with Option 2. It also enables the FMA to maintain a credible deterrence approach. Investors should, therefore, have more confidence in markets and be at less risk of harm under Option 3.

Overall, and reflecting the points above, we consider that Option 3 is likely to deliver strong value for money but, as discussed below, not as much as Option 4. Furthermore, Option 3 does not provide much scope for future proofing the FMA for likely upcoming changes to markets or increases in expectations. Option 4 is better in this regard.

Option 4

Option 4 (enhanced) is also a good option but, in our view, delivers even more benefit than Option 3 and, therefore, is preferred ahead of Option 3.

In addition to the benefits associated with Option 3, Option 4 offers some distinct advantages over and above any of the other options. In particular, Option 4:

- enables a shift to a much stronger systems focus in its work including supporting greater financial market system coordination and engagement
- enables a shift to a greater focus on customers over and above the existing focus on investors including more work on good customer outcomes, and employing innovative approaches such as behavioural economics to enhance conduct outcomes
- enables more focus on providing conduct guidance to market, thereby reducing regulatory burden
- enables deeper and faster progress to be made with understanding the FA market, the risks posed and how to address those risks
- provides the FMA with some additional resource in relation to conduct and culture thereby allowing the FMA to begin (but not execute) the process of planning and preparing for its new conduct and culture remit, maintain a higher level of momentum regarding the follow-up to the C&C reviews, and take both strategic and tactical approaches to the follow-up
- supports a significant focus on capability and building the FMA's maturity as a regulator, most notably in focusing on building expertise in areas such as thematic work, and sector and business model expertise

- provides greater capacity and ability to utilise and realise the benefits of the new technology and IT systems that, to date, has not been possible because of resource constraints.

Option 4 also delivers more benefit in several areas over and above those under Option 3. In particular, it enables deeper and faster progress to be made with understanding the FA market, the risks posed and how to address those risks. Option 4 also facilitates a higher level of momentum regarding the follow-up to the C&C review and enables the FMA to take both strategic and tactical approaches to the follow-up.

Although Option 4 involves additional funding of up to circa \$5 million compared with Option 3, this is more than outweighed by the additional benefits that are delivered by Option 4. Because of the additional features that Option 4 brings, we consider it is the preferred option.

Overall conclusion

Based on the assessment described above, we recommend Option 4 as the preferred option.

Appendix A: Restrictions

This report has been prepared for the Ministry of Business, Innovation and Employment to inform an efficiency, effectiveness and baseline review of the Financial Markets Authority. This report has been prepared solely for this purpose and should not be relied upon for any other purpose. We accept no liability to any party should it be used for any purpose other than that for which it was prepared.

This report has been prepared solely for use by the Ministry of Business, Innovation and Employment and the Financial Markets Authority and may not be copied or distributed to third parties without our prior written consent.

To the fullest extent permitted by law, PwC accepts no duty of care to any third party in connection with the provision of this report and/or any related information or explanation (together, the “Information”). Accordingly, regardless of the form of action, whether in contract, tort (including without limitation, negligence) or otherwise, and to the extent permitted by applicable law, PwC accepts no liability of any kind to any third party and disclaims all responsibility for the consequences of any third party acting or refraining to act in reliance on the Information.

We have not independently verified the accuracy of information provided to us, and have not conducted any form of audit in respect of the Ministry of Business, Innovation and Employment or the Financial Markets Authority. Accordingly, we express no opinion on the reliability, accuracy, or completeness of the information provided to us and upon which we have relied.

The statements and opinions expressed herein have been made in good faith, and on the basis that all information relied upon is true and accurate in all material respects, and not misleading by reason of omission or otherwise.

The statements and opinions expressed in this report are based on information available as at the date of the report.

We reserve the right, but will be under no obligation, to review or amend our report, if any additional information, which was in existence on the date of this report, was not brought to our attention, or subsequently comes to light.

This report is issued pursuant to the terms and conditions set out in our Consultancy Services Order dated 29 August 2019.

Appendix B: List of Interviewees

We interviewed personnel across all areas of FMA activity as indicated in the table below.

FMA Title
Chairman and Board
Chief Executive
Director of Market Engagement
Head of Compliance Services
Director of People and Capability
Manager, Recruitment
Learning Development Manager
Director of Regulation
Head of Knowledge Services
Head of Supervision
Head of Conduct Assessment
General Counsel
Head of Enforcement
Head of Evidence and Investigations
Head of Policy Governance
Head of Corporate Legal (acting)
Chief Operating Officer
Manager, Finance
Business Performance and Analysis Manager
Head of Project and Digital Services
Director of Strategy & Stakeholder Relations
Head of Strategy
Director of External Communications and Investor Capability
Manager, Investor Capability
Head of Conduct
Head of Disclosure

We also interviewed representatives from each of the following organisations.

Organisation
Ministry of Business, Innovation and Employment
Audit NZ/Office of the Auditor General
Reserve Bank of New Zealand
Serious Fraud Office
Meredith Connell
Commerce Commission
Treasury
Financial Services Council
NZX
Australian Securities and Investments Commission

Appendix C: Summary of funding needed for the baseline options

The tables below summarise the operating and capital funding, over and above current baseline, for the baseline options discussed in Part B of the report. A summary of the FTE staff numbers under each option is also provided.

Operating funding

Financial year ending June (\$ million)	FY 21	FY22	FY23	FY24
Option 1: No new funding	Nil	Nil	Nil	Nil
Option 2: Current spend	7.673	8.073	10.020	11.098
Option 3: Base	13.478	18.381	20.262	21.601
Option 4: Enhanced	15.164	23.074	25.004	26.340

Capital funding

Financial year ending June (\$ million)	FY 21	FY22	FY23	FY24
Option 1: No new funding	Nil	Nil	Nil	Nil
Option 2: Current spend	3.300	Nil	Nil	Nil
Option 3: Base	3.300	Nil	Nil	Nil
Option 4: Enhanced	3.800	Nil	Nil	Nil

FTE Staff

Financial year ending June	FY 21	FY22	FY23	FY24
Option 1: No new funding	160	160	160	160
Option 2: Current spend	211	211	211	211
Option 3: Base	238	265	265	265
Option 4: Enhanced	242	285	285	285