THE RESERVE BANK OF NEW ZEALAND: CURRENT DEVELOPMENTS

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1. Introduction

1.1 The Reserve Bank of New Zealand (the "**Reserve Bank**") is constituted under the Reserve Bank of New Zealand Act 1989 (the "**Act**"). The primary statutory function of the Reserve Bank is to formulate and implement monetary policy directed at the achievement and maintenance of price stability.[2] This function, together with those of promoting the maintenance of a sound and efficient financial system[3] and meeting the currency needs of the public[4] are the three main functions of the Reserve Bank. To these ends, the Reserve Bank is tasked with the prudential supervision of registered banks.[5]

1.2 The New Zealand banking system is dominated by foreign owned banks. All but two[6] of the 16 registered banks in New Zealand are foreign owned with the four major banks, ANZ National Bank Limited, ASB Bank Limited, Bank of New Zealand and Westpac Banking Corporation (the "**Big Four Banks**") being owned by Australian banks.[7] The Big Four Banks together hold around 85% of New Zealand's banking assets.[8]

1.3 This paper discusses certain current developments relating to the Reserve Bank's role as prudential supervisor of registered banks. Specifically, this paper considers the following areas:

- The debate regarding trans-Tasman banking supervision;
- the Implementation of Basel II by the Big Four Banks;
- the Reserve Bank's policy on the local incorporation of systemically important banks; and
- the Reserve Bank's outsourcing policy for systemically important banks.

1.4 In particular, these areas are considered in light of the unique issues faced by the Reserve Bank as a result of the Big Four Bank's ownership in Australia and the Reserve Bank's resulting approach to these areas.

2. The Reserve Bank's Approach

2.1 Before examining the particular areas set out above, it is useful to consider in general terms the approach taken by the Reserve Bank to its regulatory role. Traditionally, consistent with much of New Zealand's regulation, the Reserve

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[2] The Reserve Bank of New Zealand Act 1989 s 8.

[3] The Reserve Bank of New Zealand Act 1989 s 10.

[4] The Reserve Bank of New Zealand Act 1989 s 25.

[5] The Reserve Bank of New Zealand Act 1989 s 67.

[6] The two New Zealand owned banks are Kiwibank Limited and TSB Bank Limited.

[7] ANZ National Bank Limited is owned by Australia and New Zealand Banking Group Limited, ASB Bank Limited is owned by Commonwealth Bank of Australia, Bank of New Zealand is owned by National Australia Bank and Westpac Banking Corporation which currently operates as a branch in New Zealand.

[8] Dr Alan Bollard of the Reserve Bank of New Zealand, 'Bank regulation and supervision in New Zealand: recent and ongoing developments' (Speech delivered at the Australasian Institute of Banking and Finance, 23 March 2005) p.1.

Bank has taken a non-interventionist approach to prudential regulation, relying on market discipline and robust disclosure rules coupled with the regulatory capital requirements of Basel as its key regulatory tools. This approach has been contrasted with the prescriptive and hands-on approach of the main Australian regulator of deposit taking institutions, the Australian Prudential Regulation Authority ("**APRA**").[9]

2.2 Going forward, the difference between the approaches of the regulators seem unlikely to be so marked. Changes have recently been signalled in the Reserve Bank's approach. The genesis of these changes may lie in part in the International Monetary Fund ("**IMF**") review of the New Zealand financial system in 2004. In that review, the IMF made a number of recommendations in relation to the Reserve Bank's approach including advocating "further development of the Reserve Bank's ability to handle financial stresses by reviewing alternative approaches to manage a situation in which the solvency of a systemically important bank comes into question".[10] The change in approach has also been triggered at least in part by the creation of the ANZ National Bank in June 2004,[11] moving the last systemically important bank into Australian ownership.

2.3 The shift in approach is clear in the Reserve Bank's current Statement of Intent.[12] The Governor and Deputy Governor of the Reserve Bank observe in their joint foreword that "in banking oversight, the Bank has been implementing additional regulatory policies to maintain global standards for financial institutions, and bolster financial crisis capabilities",[13] going on to observe:

> *"Following the creation of ANZ National Bank, 85 per cent of New Zealand's banking assets are now concentrated in the four major Australian banks, lifting the potential of systemic risk in the event of a major bank failure. This has been partly behind an increase in regulatory capacity, so as to ensure that New Zealand has a resilient and efficient system, in which the failure of a single institution or critical system should not lead to a systemic financial crisis."*[14]

2.4 Despite the comments of the Reserve Bank that it does not intend to signal a "radical new approach to banking regulation"[15], the statements in the Statement of Intent and other public comment[16] by the Reserve Bank together with some of the policies discussed in this paper do appear to evidence a more hands-on approach to its prudential supervisory role.

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[9] For example, Reserve Bank of New Zealand *Trans-Tasman Banking Regulation* July 2004 p. 5.

[10] New Zealand: 2004 Article IV Consultation -- Staff Report and Public Information Notice (IMF Country Report No. 04/128), p.17.

[11] On 26 June 2004, The National Bank of New Zealand Limited amalgamated into ANZ Banking Group (New Zealand) Limited and the bank changed its name to ANZ National Bank Limited.

[12] Reserve Bank of New Zealand, *Statement of Intent,* for the period 1 July 2005 to 30 June 2008.

[13] Ibid p.3.

[14] Ibid p.3.

[15] Dr Alan Bollard of the Reserve Bank of New Zealand, 'After the National Bank acquisition: living with big Australian banks' (an excerpt from a speech delivered to the Australasian Institute of Banking and Finance, 6 November 2003) p.1. These comments were made in the context of the conditions of registration imposed on ANZ National Bank Limited.

[16] For example see Dr Alan Bollard, 'Being a responsible host: supervising foreign-owned banks' (Speech delivered at the Federal Reserve Bank of Chicago Conference: Systemic financial crises – Resolving Large Bank Insolvencies, 2 October 2004).

2.5 One area where the more prescriptive approach of the Reserve Bank can be seen is in the level of prescription applied to matters of corporate governance which historically have been more matters of "self discipline" for individual bank boards. This is, of course, consistent with the global focus on corporate governance following Enron and other corporate collapses and the passing of the Sarbanes-Oxley Act.

2.6 The corporate governance requirements of the Reserve Bank include that senior managers and directors of registered banks must be "fit and proper" and recruitment for these positions must be the sole responsibility of the New Zealand board of the bank.[17] The 'fit and proper" policy means that the Reserve Bank requires a "negative assurance"[18] when such appointments are made. The Reserve Bank also imposes requirements for board composition,[19] director attestations and an obligation on directors that they always act in the best interests of the bank[20] (rather than, as permitted under New Zealand law, its holding company).[21] These requirements are reinforced through the imposition of penalties where a bank's directors fail carry out their responsibilities. This increased prescription and increase in regulatory rigour are a common theme evident in the policies of the Reserve Bank discussed in this paper.

3. Issues relating to trans-Tasman banking supervision

3.1 In banking regulation, a distinction is drawn between home and host regulation. The regulator in a bank's home jurisdiction is generally responsible for regulation of the banking group both locally and on a global basis. In contrast, the regulator in a host jurisdiction takes responsibility for the bank's regulation on a local basis.

3.2 The Reserve Bank advocates a policy of robust host supervision. This is premised on the Reserve Bank's observation that although, in the normal course, the interests of the host and home regulators are aligned, this is not necessarily the case where a bank is in financial distress.[22] The potential

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[17] Dr Alan Bollard of the Reserve Bank of New Zealand, 'Bank regulation and supervision in New Zealand: recent and ongoing developments' (Speech delivered at the Australasian Institute of Banking and Finance, 23 March 2005) p.2.

[18] Ibid. p. 2..

[19] The following minimum requirements will generally apply for the composition of a board: (1) At least two of the bank's directors must be independent and (2) the chairperson must not be an employee of the bank. See the Reserve Bank of New Zealand, *Statement of Principles: Bank Registration and Supervision*, paragraph 57, p 13.

[20] Reserve Bank of New Zealand *Review of the regulation and performance of New Zealand's major financial institutions* (8 January 2005), para 60.

[21] Companies Act 1993 s 131 Duty of directors to act in good faith and in best interests of company
(1) Subject to this section, a director of a company, when exercising powers or performing duties, must act in good faith and in what the director believes to be the best interests of the company.
(2) A director of a company that is a wholly-owned subsidiary may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of that company's holding company even though it may not be in the best interests of the company.
(3) A director of a company that is a subsidiary (but not a wholly-owned subsidiary) may, when exercising powers or performing duties as a director, if expressly permitted to do so by the constitution of the company and with the prior agreement of the shareholders (other than its holding company), act in a manner which he or she believes is in the best interests of that company's holding company even though it may not be in the best interests of the company.
(4) A director of a company [that is carrying] out a joint venture between the shareholders may, when exercising powers or performing duties as a director in connection with the carrying out of the joint venture, if expressly permitted to do so by the constitution of the company, act in a manner which he or she believes is in the best interests of a shareholder or shareholders, even though it may not be in the best interests of the company.

[22] Dr Alan Bollard, 'Being a responsible host: supervising foreign-owned banks' (Speech delivered at the Federal Reserve Bank of Chicago Conference: Systemic financial crises – Resolving Large Bank Insolvencies, 2 October 2004) p.2.

conflicts in connection with distressed banks underlie Reserve Bank policy decisions.

APRA/Reserve Bank roles

3.3 In the case of the Big Four Banks, APRA is the home supervisor, i.e. supervising not only the Australian bank in Australia, but also the global banking group on a consolidated basis. The Reserve Bank is the host supervisor of the Australian owned banks. As host, the Reserve Bank's primary responsibility is for the bank in New Zealand, on a stand alone basis. Its focus is on capital adequacy, risk management, corporate form, governance, and stand alone operating capabilities of the bank within New Zealand.[23] Its interest in the foreign parent results from the impact that the financial condition of a parent bank has on its New Zealand subsidiary.

3.4 In theory, both home and host supervisors can benefit in obvious ways from each other's supervision. The Reserve Bank acknowledges the benefit that the New Zealand financial system derives from the role played by APRA, and the other home-country regulators.[24] However, the Reserve Bank has also noted the following potential divergences between supervisory authorities:[25]

- **Different statutory objectives** - for example, some supervisors have depositor protection as their main objective, while others have soundness and stability. As mentioned above, section 8 of the Act provides that the Reserve Bank's primary function is to maintain financial stability. In contrast, APRA's statutory objective in section 12 of the Banking Act 1959 (*Commonwealth of Australia*) provides "it is the duty of APRA to exercise its powers and functions ...for the protection of the depositors of the several Authorised Deposit Taking Institutions (ADIs)." This is underlined by section 13A(3) of the Australian Act which provides as follows:

  > "*if an ADI becomes unable to meet its obligations or suspends payment, the assets of the ADI in Australia are to be available to meet that ADI's deposit liabilities in Australia in priority to all other liabilities of the ADI*"

  This contrast demonstrates a marked difference in statutory objectives between the Reserve Bank and APRA.

- **How capital should be allocated** - each supervisory authority would like to see as much capital reside within its own jurisdiction as possible. Tensions between home and host authorities can arise when a host authority requires that the parent inject more capital to prevent under-capitalisation.

- **How risk should be allocated** - each supervisory authority would prefer that risk resides outside its own system in times of financial stress. The Reserve Bank considers that this may influence the allocation of capital and cause tension between the home and host authority.[26]

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[23] Ibid p.4..

[24] Ibid p.1.

[25] Dr Alan Bollard of the Reserve Bank of New Zealand, 'Bank regulation and supervision in New Zealand: recent and ongoing developments' (Speech delivered at the Australasian Institute of Banking and Finance, 23 March 2005) p.5.

[26] Dr Alan Bollard, 'Being a responsible host: supervising foreign-owned banks' (Speech delivered at the Federal Reserve Bank of Chicago Conference: Systemic financial crises – Resolving Large Bank Insolvencies, 2 October 2004) p.2.

- **Each supervisory authority is only responsible for financial stability in its own system** - the effects on the financial systems of other jurisdictions of any actions taken to manage a bank failure in one's own jurisdiction are likely to be considered second order. APRA has no statutory imperative to consider the down stream effect on the New Zealand financial system resulting from an Australian banking crisis. In fact, the reverse applies.

- **Different views on appropriate techniques for responding to bank stress** – there is generally a range of options available to prudential supervisors at times of financial stress. Choices range from institutional bail-outs to liquidation and, in some circumstances, other options in between.[27] In New Zealand and Australia, both the Reserve Bank and APRA have broad powers to place a failing bank into statutory management, although this is only one option. Given the range of options available at times of bank stress, the risk exists that APRA's approach will differ from the Reserve Bank's, particularly given the differing statutory goals.

- **Different perceptions of when a crisis is systemic** – this is a particular risk when the subsidiary plays a larger role in the host's system than the parent plays in the home system. Australian banks that own systemically important banks in New Zealand are also the largest four banks in Australia.[28] However, this could be with different degrees of significance dependent on relative proportions of banking assets.

- **Each system may also be subject to different destabilising influences** - the health and stability of other areas of the economy will affect the banking system. Although the New Zealand and Australian financial systems are very interlinked, the potential remains for events to impact the two systems to different degrees. An example of this may be specific agriculture events such as a foot and mouth outbreak in one country but not the other. Another example could be the impact of terrorist attacks in one country only.

3.5 The consequence of these divergences are distilled to the overriding concern of the Reserve Bank - in the event of a banking crisis, the Reserve Bank, as host supervisor, cannot rely on the home supervisor to act in the interests of the host's financial system:[29]

> *"We need to continue to place importance on our ability to supervise the New Zealand banking system and to respond to a banking crisis in ways that enable us to protect New Zealand's interests without placing undue reliance on the actions of the home authorities. This being said, we also recognise that the most effective response to a cross border crisis would desirably involve close co-operation and co-ordination between the home and host authorities".*

3.6 Accordingly, the Reserve Bank considers its [30] "dual aims are to maintain the capacity to protect the New Zealand financial system on a stand alone basis,

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[27] Ibid p.3.

[28] Reserve Bank of New Zealand, *Financial Stability Report*, May 2005, p.18.

[29] Dr Alan Bollard, 'Being a responsible host: supervising foreign-owned banks' (Speech delivered at the Federal Reserve Bank of Chicago Conference: Systemic financial crises – Resolving Large Bank Insolvencies, 2 October 2004) p.3.

[30] Ibid p.3.

while also building the framework for closer co-ordination between the host and home authorities," going on to note "the co-ordination of such supervisory arrangements in ways that meet the needs of both countries is both complicated and challenging".[31]

Reserve Bank co-operation with APRA

3.7 Notwithstanding the potential for conflict between the interests of APRA and the Reserve Bank, the Reserve Bank has observed that it has sought to dovetail its supervisory arrangements with APRA in order to keep banks' compliance costs relatively low and to avoid excessive operational inefficiencies for banks.[32]

3.8 Some of the Reserve Bank's recent initiatives with APRA were outlined by Doctor Alan Bollard in an address to the Australian Institute of Banking and Finance in March 2005 and include the following:[33]

- the initiation of a secondment strategy of senior staff members between APRA and the Reserve Bank;
- the establishment of Terms of Engagement with APRA so that it can co-ordinate its Basel II implementation initiatives. This is discussed in more detail below;
- the Reserve Bank has agreed to share visits to Australian owned banks on either side of the Tasman with APRA staff;
- the Reserve Bank and APRA have signed a memorandum of understanding[34] to facilitate better information sharing between the two institutions;
- co-ordinating policy development. The Reserve Bank says that it seeks to avoid unnecessary conflicts in the specification of regulations for New Zealand banks with those issued by APRA for its global banking group with the goal of minimising banks' compliance costs;[35]
- the Reserve Bank is attempting to establishing a clear understanding regarding the roles, responsibilities, powers, and arrangements among New Zealand and Australian government agencies for responding to stress in a bank operating in both New Zealand and Australia;

[31] Ibid p.2.

[32] Ibid p.4.

[33] Dr Alan Bollard of the Reserve Bank of New Zealand, 'Bank regulation and supervision in New Zealand: recent and ongoing developments' (Speech delivered at the Australasian Institute of Banking and Finance, 23 March 2005) p.5.

[34] Memorandum of Understanding between the Reserve Bank of New Zealand and the Australian Prudential Regulation Authority, 16 July 2003.

[35] Dr Alan Bollard of the Reserve Bank of New Zealand, 'Bank regulation and supervision in New Zealand: recent and ongoing developments' (Speech delivered at the Australasian Institute of Banking and Finance, 23 March 2005) p.6.

- clarifying uncertainties that arise from differences in national banking laws;
- taking account of the need for trans-Tasman co-ordination in strengthening our own preparedness for responding to a banking crisis; and
- considering the cross border issues and implications that could arise in relation to our role as lender of last resort to the New Zealand financial system.

3.9 These initiatives of the Reserve Bank and APRA appear to evidence a desire to co-operate. Perhaps, unsurprisingly, the Reserve Bank has made much more public comment about its desire to co-operate and co-ordinate than APRA. Having said that, few of the initiatives listed above are very tangible evidence of co-operation between the two institutions which will lead to efficiency gains to the Big Four Banks. It is also interesting to note that the Reserve Bank has received some resistance in its trans-Tasman efforts from Australian officials who await a "political steer".[36] Perhaps one thing, however, which suggests that trans-Tasman co-operation in banking regulation may be more likely to succeed than in many areas is the apparent willingness of politicians on each side of the Tasman to forge strong links.

3.10 This willingness was evidenced in February 2005 with the announcement by New Zealand's Minister of Finance, the Honourable Doctor Michael Cullen, and the Australian Treasurer, the Honourable Peter Costello MP of the formation of a Trans-Tasman Council on Banking Supervision. The Council's role is to promote a joint approach to trans-Tasman banking supervision that delivers a seamless regulatory environment[37].

3.11 Since the Council's establishment, debate has intensified as to whether the New Zealand financial system should be supervised by a single trans-Tasman regulator. Early on, the Reserve Bank, Treasury and Ministry of Economic Development were reported as opposing the push towards a single regulator, warning Doctor Cullen of potential tax losses, head office job losses and restrictions on growth.[38] They were also concerned about the potential "hollowing out" of New Zealand banking operations by Australian parent banks and the various impacts of this on New Zealand.[39] The Reserve Bank's view is captured in the following statement by Doctor Alan Bollard in response to

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[36] Reserve Bank of New Zealand *Talking points for Minister of Finance's meeting with Australian Treasurer*, 17 February 2005, p.2.

[37] Media Release 17 February 2005: http//:www.cch.co.nz

"In particular the Council's terms of reference provide that it will:

- enhance cooperation on the supervision of trans-Tasman banks and information sharing between respective supervisors;
- promote and review regularly trans-Tasman crisis response preparedness relating to events that involve banks that are common to both countries;
- guide the development of policy advice to both governments, underpinned by the principles of policy harmonisation, mutual recognition and trans-Tasman coordination;
- in the first instance, the Council was scheduled to report to Ministers by 31 May 2005 on legislative changes that may be required to ensure APRA and the Reserve Bank can support each other in the performance of their current regulatory responsibilities at least regulatory cost. However, at the time of writing, a report had not been provided to Ministers.

The Council is chaired jointly by the Secretaries to the Treasuries of Australia and New Zealand, and also comprises senior officials from APRA, the Reserve Bank and the Reserve Bank of Australia.

[38] 'NZ bank chiefs cool on Aussie plan', *The Dominion Post* (Wellington, New Zealand) 1 March 2005, Business, p.3.

[39] 'NZ bank chiefs cool on Aussie plan', *The Dominion Post* (Wellington, New Zealand) 1 March 2005, Business, p.3.

comment that the Trans-Tasman Council on Banking Supervision is viewed by Peter Costello as a forerunner to a joint regulator:[40]

"the council is not based on statute and does not derogate in any way the Reserve Bank's responsibilities"

3.12 By contrast, Peter Costello has signalled that a single banking regulator to monitor both countries is the preferred option for Australia.[41] One imagines that the likely method of this would be the Reserve Bank losing its supervisory role, moving to the Australian model where the two central bank roles have been separated, with the Australian Reserve Bank responsible for monetary policy, and APRA responsible for regulating the financial sector.

3.13 The opinion of the current New Zealand government on the debate is represented by Doctor Cullen. He has been reported as saying: *"I think we will end up with a single regulator in New Zealand of financial institutions at the prudential level, which may or may not be the Reserve Bank."*[42] However, he has also been reported as giving his assurance that the Reserve Bank's supervisory role will not be removed by a review of trans-Tasman banking regulations.[43] Doctor Cullen's current view appears to be captured in his statement that the Australian and New Zealand Governments are close to a deal harmonising banking regulations which is likely to see an *"over arching"* body covering trans-Tasman banking issues, although it would be working alongside separate prudential regulators in each country.[44] Accordingly, the Reserve Bank's supervisory role, at least for the moment, seems safe.

3.14 There does not seem to be significant public support, even among the Big Four Banks, for a single regulator. Perhaps this is because they are concerned that any efficiencies gained by a single regulator would be outweighed by the hands-on approach of APRA. Ann Sherry, Chief Executive of Westpac New Zealand has said that while both Michael Cullen and Peter Costello have taken note that harmonised regulations may point to one joint regulator, due to the large degree of integration of the two countries' banking systems, a joint regulator would need to be "genuinely trans tasman" to be effective.[45]

3.15 Other commentators have also not been supportive. These include both people from the business community and academics.[46] For example Tim Brown of Infratil has observed that "it is not realistic to expect a foreign official in such a situation to be willing to have New Zealand's best interests at heart".[47] Professor Ed Kane of Boston College, an American expert on

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[40] Greg Tourelle 'Buck still stops at Bank, says Bollard' *The New Zealand Herald*, (Auckland, New Zealand), 24 March 2005, Business.

[41] Peter Costello opined at a press-conference on 17 February 2005 "let's start off with an ambitious agenda" in the context of a move towards a single trans-Tasman regulator. He also said "what is not open, in my view, would be two regulators, different depositor protection and different rules. Because that would be leading to duplication and unnecessary costs."

[42] Ibid.

[43] Ibid.

[44] Gareth Vaughan 'Cullen softens bank remark' *The New Zealand Herald*, (Auckland, New Zealand), 11 June 2005 Business, general.

[45] Ann Sherry, 'Transtasman bank link is about reality', *New Zealand Herald* (Auckland, New Zealand), 27 April 2005, National News.

[46] Gareth Vaughan 'Cullen softens bank remark' *The New Zealand Herald*, (Auckland, New Zealand), 11 June 2005 Business, general.

[47] Tim Brown 'Transtasman debate needs to be honest' *New Zealand Herald*, (Auckland, New Zealand), 11 April 2005, National News.

banking regulation who has spent time studying the New Zealand system also strongly opposes a joint regulator for Australia and New Zealand. He prefers the New Zealand regulation system to Australia's and is reported to have said "New Zealand would lose out if the two countries established a joint regulator".[48]

3.16 In this area, there is still considerable water to flow under the bridge before there is resolution of the issue.

4. Implementation of Basel II

4.1 An area in which there is clear trans-Tasman co-operation is the implementation of the Basel II, regulatory capital rules.

4.2 In considering Basel II, it is useful to place it in its historical context. The Basel Committee developed the current 1988 Basel Capital Accord in order to bring into line the capital requirements of banks that operated in more than one country. In the simplest terms, Basel I was a framework to regulate the amount of capital that banks (and other regulated deposit-taking institutions) should hold to safeguard against risk and to absorb unforeseen losses. The 1988 Basel Accord is a prescriptive framework which provides banks with little choice as to how to calculate risk and therefore how much capital to hold. It adopts a "one size fits all" approach that has been observed to be no longer applicable to the increasing complex risk environment of the modern banking industry.[49]

4.3 Accordingly, recognising that the banking marketplace has changed since 1988, the Basel Committee has revised the Basel I framework leading to the development of the Basel II framework.[50] The earliest date that Basel II is intended to be implemented is by the end of 2007.

4.4 Basel II is intended to provide greater flexibility and it will allow banks to apply a more "risk sensitive methodology to the measurement of regulatory capital."[51] This is because it allows banks to use their own internal estimates of risk provided that the bank follows guidelines set by supervisors and has its supervisor's approval.[52]

4.5 The Basel II framework still permits a bank which chooses not to use its own internal risk measurements to be able to measure its risks by using "standardised approaches" substantially similar to Basel I. The standardised approaches are available to those banks whose type of business, type of risk and risk management and measurement practices do not require the application of the more advanced internal ratings based approaches.[53]

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[48] Adam Bennett 'Joint regulator a bad idea warns US expert; *New Zealand Herald,* (Auckland, New Zealand), 8 March 2005, Business.

[49] Bernie Egan, 'Basel II' (Speech delivered at the Australasian Institute of Banking and Finance and University of Western Sydney Conference, Sydney, 3 August 2003) p.2.

[50] Basel Committee on Banking Supervision *International Convergence of Capital Measurement and Capital Standards* June 2004 p.1.

[51] Bernie Egan 'APRA Update: Basel II Implementation in Australia' (Speech delivered at the Australian Financial Review's 5th Annual BankTech Conference, 14 September 2004) p.1.

[52] Ibid p.1.

[53] Ibid p.1.

4.6 As with Basel I, the Basel II framework is comprised of what are called the three pillars.

4.7 The first pillar determines minimum capital requirements. Minimum capital requirements are the level of capital banks are required to hold as a buffer against risks related to credit, market and operational risk.[54] The definitions of eligible capital, off-balance sheet credit risk and market risk remain essentially unaltered from those found in Basel I. The big change has been the addition of operational risk to Pillar 1. The Basel Committee on Banking Supervision defines operational risk as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events".[55] This means that even where a bank has "sold" its credit risk, it will have to hold capital to protect itself against the associated operational risk despite the fact that the assets have been removed from the balance sheet.[56]

4.8 There will be three alternatives for the calculation of credit risk: standardised, foundation internal ratings-based and advanced internal ratings-based. There will also be three alternatives for the calculation of operational risk; standardised, basic indicator and advance measurement approaches.

4.9 The second pillar provides for supervisory review processes. It requires supervisors to review the assessments made by the banks and to take action against the banks where necessary.[57]

4.10 The third pillar provides for mandatory disclosures by banks to the market, designed to guarantee that market discipline successfully compliments pillar 1 and 2 requirements.[58] It does so through making supervisors require disclosure and set guidelines for such disclosure. The disclosure allows others in the market to assess key data regarding the risk profile of a bank and the amount of capital it holds.

4.11 Historically, the Reserve Bank has focussed on Pillar III in contrast to APRA's reliance on Pillar II. APRA watches banks closely through a combination of on-site tests of banks, discussions with banks and analysis of information that the banks provide to them. In contrast, the Reserve Bank has traditionally placed greater responsibility for the operation of banks on its directors and senior management and public disclosure requirements.

Co-operation between the Reserve Bank and APRA

4.12 As discussed above, both Australia and New Zealand supervise Australian owned banks operating in New Zealand.

4.13 The Basel Committee recognises that cooperation is needed between home and host country supervisors for the implementation of Basel II. It has provided the following principles to reduce the associated burden for banks that operate in more than one country and those bodies that supervise them:

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[54] Basel Committee on Banking Supervision *International Convergence of Capital Measurement and Capital Standards* June 2004 p 12.

[55] Ibid p 137.

[56] Bernie Egan 'APRA Update: Basel II Implementation in Australia' (Speech delivered at the Australian Financial Review's 5th Annual BankTech Conference, 14 September 2004) p.4.

[57] Basel Committee on Banking Supervision *International Convergence of Capital Measurement and Capital Standards* June 2004 p 158.

[58] Ibid p 3.

- "The New Accord will not change the legal responsibilities of national supervisors for the regulation of their domestic institutions or the arrangements for consolidated supervision already put in place by the Basel Committee on Banking Supervision;
- The home country supervisor is responsible for the oversight of the implementation of the New Accord for a banking group on a consolidated basis;
- Host country supervisors, particularly where banks operate in subsidiary form, have requirements that need to be understood and recognized;
- There will need to be enhanced and pragmatic cooperation among supervisors with legitimate interests. The home country supervisor should lead this coordination effort;
- Wherever possible, supervisors should avoid performing redundant and uncoordinated approval and validation work in order to reduce the implementation burden on the banks, and conserve supervisory resources; and
- In implementing the New Accord, supervisors should communicate the respective roles of home country and host country supervisors as clearly as possible to banking groups with significant cross-border operations in multiple jurisdictions. The home country supervisor would lead this coordination effort in cooperation with the host country supervisors."[59]

4.14 In the Reserve Bank's talking points for the Minister of Finance's meeting with the Australian Treasurer, the Reserve Bank stated its policy regarding Basel II to be that "[T]he RBNZ wishes to implement Basel II in a way that dovetails as much as possible with APRA's intended implementation approach, while remaining consistent with its statutory objectives and taking account of the special features of our financial environment."[60]

4.15 The Reserve Bank has also said that it seeks to implement Basel II in a manner that strikes a balance between the consistent adoption of Basel II methodology and retaining the capacity to regulate capital requirements in consideration of the host country's risks.[61]

4.16 Against this background, the Reserve Bank and APRA have entered into Terms of Engagement on the implementation of Basel II Capital Rules.[62]

4.17 The Reserve Bank has characterised the The Terms of Engagement as high-level principles intended to guide the harmonisation of cross-border implementation of Basel II in Australia and New Zealand.[63] The Terms of Engagement state that APRA and the Reserve Bank "recognise that the new Basel Capital Framework offers a means to strengthen risk management by banks and to ensure that regulatory capital held by banks is appropriate in light of their risk profiles."[64] The objectives of the Terms of Engagement provide as follows:

> *"APRA and the Reserve Bank intend to implement Basel II in Australia and New Zealand in a manner that:*

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[59] Basel Committee on Banking Supervision *High-level principles for the cross-border implementation of the New Accord* August 2003.

[60] Reserve Bank of New Zealand *Talking points for Minister of Finance's meeting with Australian Treasurer* 17 February 2005 p.2.

[61] Dr Alan Bollard, 'Being a responsible host: Supervising foreign-owned banks' (Speech delivered that the Federal Reserve Bank of Chicago Conference: Systemic Financial Crises – Resolving Large Bank Insolvencies, 2 October 2004) p.6.

[62] APRA and the Reserve Bank of New Zealand, 'Terms of Engagement Implementation of new Basel Capital Framework for banks with operations in both Australia and New Zealand', 17 March 2005.

[63] Letter from Adrian Orr of the Reserve Bank of New Zealand to all NZ Banks on 17 March 2005 re the implementation of Base II in New Zealand p.1.

[64] APRA and the Reserve Bank of New Zealand, 'Terms of Engagement: Implementation of new Basel Capital Framework for banks with operations in both Australia and New Zealand', 17 March 2005 p.1.

- *Recognises a home supervisor's rights to set minimum levels of capital on a consolidated basis for banking groups with operations in several jurisdictions;*
- *Recognises a host supervisor's rights to set minimum levels of capital for banks incorporated in the host supervisor's jurisdiction; and*
- *Optimises the use of supervisory resources and reduces compliance costs to the extent possible, subject to adequate supervisory review of capital adequacy at the consolidated and subsidiary levels."*[65]

4.18 The Terms of Engagement also state that:

"[S]ubject to these objectives, APRA and the Reserve Bank will aim to ensure that the approaches to regulatory capital adequacy requirements in each jurisdiction are harmonised and mutually consistent to the extent possible."[66]

4.19 The Terms of Engagement also include operating guidelines such as APRA and the Reserve Bank undertaking supervisory reviews of banks in both jurisdictions in such a way to best utilise each supervisor's comparative advantage and knowledge base.[67] To prevent overlap between the home supervisor and the host supervisor, the Terms of Engagement also provide that the local supervisor will set minimum regulatory capital requirements on a legal entity basis where that legal entity is incorporated.[68]

4.20 Banking groups operating in both Australia and New Zealand can be somewhat encouraged at this engagement in this very complex area. It is clear that a significant divergence of approach between the two regulators would lead to even more significant expense than will otherwise be required. It is also clear from the Terms of Engagement that, as discussed above, the "sovereignty" of the two regulators is retained.

Implementation of the Basel II Capital Rules in New Zealand

4.21 The Reserve Bank has not made significant public comment on the detail of its Basel II implementation. Indeed, the Reserve Bank has not stated when it expects implementation of Basel II to take place but it has said that it did not expect it to take place before other foreign supervisors.[69]

4.22 In relation to Pillar I regulatory capital requirements, despite having indicated at one stage that only the standardised approaches would be available in New Zealand,[70] on 17 March 2005 the Reserve Bank announced that it would make all approaches to credit-risk and operational risk provided by Basel II available in New Zealand.[71] It did so to increase its harmonisation with APRA in the implementation of Basel II.[72] It went on to qualify this statement by saying that

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[65] Ibid p.1.

[66] Ibid p.1.

[67] Ibid p.1.

[68] Ibid p.1.

[69] Letter from Adrian Orr of the Reserve Bank of New Zealand to all NZ Banks on 17 March 2005 regarding the implementation of Basel II in New Zealand p.1.

[70] Letter from Adrian Orr of the Reserve Bank of New Zealand to the CEOs of all registered banks on 25 July 2003 regarding an update on Reserve Bank of New Zealand's position regarding the new Basel II Capital Accord p.1.

[71] Letter from Adrian Orr of the Reserve Bank of New Zealand to all NZ Banks on 17 March 2005 regarding the implementation of Basel II in New Zealand p.1.

[72] Dr Alan Bollard of the Reserve Bank of New Zealand, 'Bank regulation and supervision in New Zealand: recent and ongoing developments' (Speech delivered at the Australasian Institute of Banking and Finance, 23 March 2005) p.3.

the approaches based on internal risk modelling would only be available to banks who met certain criteria.[73]

4.23 This means there is the ability for banking group's operating in both jurisdictions to have some consistency of approach. This should give rise to efficiency gains in terms of systems. However, it is important to note in this context that the Reserve Bank's focus on corporate governance is relevant in New Zealand banks' implementation of Basel II.

4.24 The Reserve Bank has made very clear that responsibility and accountability for all bank operations remains with the New Zealand board where the New Zealand bank adopts the methodology for calculating risk from its parent bank.[74] Consequently, although New Zealand banks may follow their parent bank's method for the implementation of Basel II, this is on the proviso that the method they adopt also provides for the bank's directors to simultaneously comply with all duties placed on them under New Zealand law.[75] This highlights the degree of ownership placed on New Zealand boards by the Reserve Bank and is consistent with Basel II's corporate governance requirements[76]

4.25 We also note that the Reserve Bank have said that likely changes under Basel II include amendments to the disclosure requirements under Pillar 2.[77]

Implementation of the Basel II Capital Rules in Australia

4.26 APRA has confirmed that it will implement Basel II through its Prudential Standards for all its authorised deposit-taking institutions (ADIs).[78]

4.27 APRA expects the four major Australian banks to adopt the advanced approaches for credit and operational risk. It is expected that the majority of other banks will implement the standardised approaches.

4.28 Some indications suggest that the implementation of Basel II will allow Australian banks to hold less capital but APRA has stipulated that only modest decreases in the amount of capital held by banks is expected.[79]

4.29 APRA will allow banks the freedom to choose what type of approach it wishes to apply. However it will require banks to be consistent with the way that they choose to utilise the principles of Basel II. Where a bank chooses to use one

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[73] Letter from Adrian Orr of the Reserve Bank of New Zealand to all NZ Banks on 17 March 2005 re the implementation of Base II in New Zealand p.1. What these criteria are has not been disclosed.

[74] Dr Alan Bollard of the Reserve Bank of New Zealand, 'Bank regulation and supervision in New Zealand: recent and ongoing developments' (Speech delivered at the Australasian Institute of Banking and Finance, 23 March 2005) p.2.

[75] These include duties under the Companies Act 1993 and director's attestation of disclosure statements.

[76] See pages 90-91 of Basel Committee on Banking Supervision *International Convergence of Capital Measurement and Capital Standards* June 2004.

[77] Dr Alan Bollard of the Reserve Bank of New Zealand, 'Bank regulation and supervision in New Zealand: recent and ongoing developments' (Speech delivered at the Australasian Institute of Banking and Finance, 23 March 2005) p.3.

[78] Bernie Egan 'APRA Update: Basel II Implementation in Australia' (Speech delivered at the Australian Financial Review's 5th Annual BankTech Conference, 14 September 2004) p.2.

[79] Bernie Egan, 'Basel II' (Speech delivered at the Australasian Institute of Banking and Finance and University of Western Sydney Conference, Sydney, 3 August 2003) p.3.

method of calculating a particular type of risk it must be consistent and use that method for calculating all types of risk.[80]

4.30 APRA does not expect Basel II to be implemented in Australia until the end of 2007 despite the Basel Committee having made parts of Basel II available for implementation from year-end 2006. The rationale is that APRA believes that there is a strong case for a common starting point.[81] One would imagine that the timetable in New Zealand is likely to be the same.

5. Reserve Bank policy on locally incorporation of systemically important banks

5.1 The Reserve Bank characterises systemically important banks as those "which are so large that their failure could have flow on effects to the banking system as a whole and the wider economy".[82] This has been quantified by the Reserve Bank "as those whose New Zealand liabilities net of amounts due to related parties exceed $10 billion."[83] The Reserve Bank focuses on systemically important banks because they pose the greatest threat of causing significant damage to the New Zealand financial system in the event of failure. Currently, the systemically important banks in New Zealand are the Big Four Banks.

5.2 The Reserve Bank considers that damage caused by the financial failure of a systemically important bank could include:[84]

- the liquidity implications to the economy as a result of a bank being unable to meet its payments and settlement obligations;
- the propagation of financial distress to the bank creditors, in particular other banks; and
- the implications for consumer and investor confidence in other banks and the financial system as a whole.

5.3 Accordingly, to reduce the impact of a bank failure, the Reserve Bank considers it crucial that a systemically important bank is able to continue to operate even though it may have failed financially. This has led to the implementation of paragraph 26 of Reserve Bank's Statement of Principles: Bank Registration and Supervision which requires systemically important banks to incorporate locally, rather than operate as a branch of a foreign bank.[85]

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[80] Ibid p.2.

[81] Ibid p.2.

[82] Reserve Bank of New Zealand, *Statement of Principles: Bank Registration and Supervision*, paragraph 26, p 7-8.

[83] Ibid paragraph 26, p 8.

[84] Reserve Bank of New Zealand, News Releases, '*RBNZ releases draft outsourcing rules for banks*', 2 November 2004.

[85] Section 75 of the Reserve Bank of New Zealand Act 1989 requires the Reserve Bank to publish the principles on which it acts. These principles are set out in the Reserve Bank's 'Statement of Principles'. These principles act as a basis on which the Reserve Bank carries out aspects of its prudential supervisory role. It should be noted that in some circumstances the Principles may require other banks to incorporate in New Zealand. Incorporation may be required where retail deposit takers are incorporated in a jurisdiction (such as Australia) that has legislation which gives deposits made, or credit conferred, in that jurisdiction a preferential claim in a winding up.

5.4 The Reserve Bank has identified the following three main objectives of its local incorporation policy:[86]

(a) to enable the Reserve Bank to respond to a financial crisis effectively, in New Zealand's interests as it provides a higher degree of certainty over the balance sheet of the bank in New Zealand, – the theory being that the statutory managers can assume control of a failed or distressed bank with greater certainty over legal jurisdiction than they would in the case of a branch;

(b) to enhance the ability of the Reserve Bank to supervise the banks on an ongoing basis in the interests of New Zealand financial system. In the view of the Reserve Bank, local incorporation makes it much more difficult, legally and practically, for assets to be removed from the local operation to the parent bank; and

(c) to establish a basis for sound bank governance in the host country, including a board of directors with the responsibility to act in the interests of the local bank.

5.5 The Reserve Bank places weight on the protective provisions of the New Zealand Companies Act.[87] A locally incorporated bank has its own board of directors and those directors are required under the Companies Act 1993 to act in the best interests of the company, to prevent the company from carrying on business in a manner likely to create a substantial risk of serious loss to the company creditors and to ensure that the company does not incur an obligation unless they believe that the company will be able to perform the obligation when required to do so. They must also ensure that they pass a solvency test prior to making a distribution to shareholders. The Reserve Bank believes that these directors' duties provide much greater certainty in a failure situation and increase the likelihood of value being retained in the New Zealand bank prior to the failure.[88]

5.6 The Reserve Bank's incorporation requirement has specifically impacted Westpac, being currently the only systemically important bank that is not incorporated in New Zealand. The Reserve Bank has been the subject of criticism in light of its policy. These criticisms include:

- The Reserve Bank has given insufficient weight to the efficiency losses which result from local incorporation.[89] These include the cost of maintaining a local board and the associated governance issues.

- Local incorporation may not provide New Zealand depositors any greater protection than a branch structure and the Reserve Bank has not made available any evidence that local incorporation will ring-fence the assets of the New Zealand branch.[90] New Zealand depositors may be worse off because local incorporation removes the security of Westpac's global

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[86] Dr Alan Bollard, *'Systemic financial crises – resolving large bank insolvencies'*, Address to the Federal Reserve Bank of Chicago Conference, 2 October 2004.

[87] Companies Act 1993.

[88] Reserve Bank of New Zealand, *Statement of Principles: Bank Registration and Supervision*, paragraph 28, p 8.

[89] Evans L & Quigley N, *'An Analysis of the Reserve Bank of New Zealand's Policy on the Incorporation of Foreign Banks'* published by the New Zealand Institute for the Study of Competition and Regulation Inc, 20 May 2002, p 48.

[90] Ibid.

balance sheet as there is no guarantee that the parent will ensure payment in full for New Zealand depositors should its subsidiary collapse.[91]

- the nature of trans-Tasman banking technology (and the expeditious electronic transfer of funds) meant that there could be no real assurances that New Zealand banking assets would not be removed to Australia should an Australian bank suffer collapse.[92]

5.7 These criticisms are interesting points. Perhaps the most interesting from a legal perspective is the question of whether local incorporation affords any greater protection to New Zealand depositors. The depositor protection legislation in Australia (described above) has been counter-balanced by section 23(2) of the Westpac Banking Corporation Act 1982 (New Zealand) which provides for similar preferential treatment for New Zealand depositors in respect of claims on the New Zealand assets of the foreign bank. The section provides: ["In the event of the Continuing Bank (Westpac Banking Corporation) becoming unable to meet its obligations or suspending payment, the Assets of the Continuing Bank in New Zealand shall be available to meet the Continuing Bank's deposit liabilities in New Zealand in priority to all other liabilities of the Continuing Bank". Accordingly, New Zealand depositors should rank ahead of Australian depositors in claims over the New Zealand assets of Westpac. This legal protection should have gone some considerable way to mitigating the concerns of the Reserve Bank leaving the remaining point being the issue of ensuring that sufficient assets are maintained in New Zealand to make the provision meaningful.

5.8 In response to the Reserve Bank's requirement to incorporate, Westpac submitted a proposal called the "Buttressed Branch" proposal as an alternative to compliance with the local incorporation policy. The details of the "Buttressed Branch" proposal are not publicly available. One can imagine that it would have identified ways to deal with risk of asset-leakage by ring-fencing capital in New Zealand. However, the Reserve Bank concluded that Westpac's Buttressed Branch proposal was not acceptable as an alternative to compliance with the local incorporation policy. It appears that the Reserve Bank was not able to be comfortable that New Zealand would not come out second-best in an insolvency of an Australian Bank and has led to Westpac agreeing to incorporate a New Zealand subsidiary to comply with the Reserve Bank's policy.

5.9 Incorporation will undoubtedly present a myriad of practical difficulties for Westpac. These could be expected to include tax issues, employment issues[93] and other logistical issues, not to mention the associated expense involved in the move. It does not seem clear that the perceived legal protection outweighs, in practical terms, these difficulties.

6. Reserve Bank of New Zealand's outsourcing policy for banks

Statutory Background

6.1 One of the themes running through Part 5 of the Reserve Bank Act is the imperative on registered banks to carry on business in a prudent manner. The

[91] Ibid p 49.

[92] Interview with David Tripe of Massey University (telephone interview, 20 July 2005).

[93] Westpac has more than 6,000 staff in New Zealand.

ability of a bank to carry on its business in a prudent manner is one of the things the Reserve Bank must have regard to before registering a bank[94] and failure to do so is one of the bases on which a registered bank may be de-registered.[95]

6.2 Section 78 of the Act contains the finite list of matters to which the Reserve Bank must confine its consideration in assessing the question of whether or not a bank carries on business in a prudent manner. Two of these matters are particularly relevant in the context of outsourcing. The first is contained in section 78(1)(e) which provides for the consideration of the "separation of the business or proposed business from other business and from other interests of any person owning or controlling the applicant or registered bank".[96] The second matter is contained in section 78(1)(fb) which provides for the consideration of "arrangements for any business, or functions relating to any business, of the applicant or registered bank to be carried on by any person other than the applicant or registered bank".[97]

6.3 Section 68 of the Act provides:

> The powers conferred on the Governor General, the Minister, and the [Reserve] Bank by this part of this Act shall be exercised for the purposes of:
>
> (a) Promoting the maintenance of a sound and efficient financial system; **or**
>
> (b) Avoiding significant damage to the financial system that could result from the failure of a registered bank.

6.4 The Reserve Bank's has highlighted what it considers three particular risks associated with outsourcing which have potential for regulatory concern:[98]

(a) *Vulnerability to failure of service providers.* In the event of a failure if an alternate provider cannot quickly be provided, a bank that relies on that service provider for a critical service is vulnerable to the failure of that service provider. Furthermore, the financial system is vulnerable to such failures particularly where a number of banks are dependent on the same service provider.

(b) *Manageability of operational risk.* While a bank can ensure strong internal controls exist to assess its own processes, it cannot, to the same extent, ensure the service provider manages and assesses their operational risk to the same level.

(c) *Manageability of legal risk.* By outsourcing, a bank may increase the risk associated with its legal ability to control functions. They may also expose themselves to the service providers' breaches of obligations owed to the bank's customer e.g. confidentiality.

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[94] Reserve Bank of New Zealand Act 1989 s 73.

[95] Reserve Bank of New Zealand Act 1989 s 77.

[96] Reserve Bank of New Zealand Act 1989 s 78(1)(e).

[97] Reserve Bank of New Zealand Act 1989 s 78(1)(fb).

[98] Reserve Bank of New Zealand, *Reserve Bank of New Zealand Consultation Paper: Proposed Outsourcing Policy for Systemically Important Banks*, (October 2004), page 4 para 8.

6.5 The Reserve Bank considers that its outsourcing policy proposals pursue the objectives of section 68 "through ensuring that any outsourcing by a systemically important bank does not compromise the ability of the bank:

(a) to be effectively administered under statutory management for the purposes of maintaining the bank's ability to continue to provide and circulate liquidity to the financial system and wider economy;

(b) to be in a position enabling any new owner of all or part of the bank to carry on the business of the bank;

(c) to continue carrying on business despite the failure of a service provider; and

(d) to capture any efficiency, cost and risk-reduction advantage that outsourcing may provide, subject to objectives (a), (b) and (c) being met."[99]

6.6 Objectives (a), (b) and (c) above relate to "stand-alone capability" which is at the heart of the draft policy.

Proposed Policy

6.7 The Reserve Bank published its draft outsourcing policy for systemically important banks in October 2004.[100]

6.8 The proposed policy would apply to all systemically important banks including Westpac, prior to its local incorporation. Consistent with its approach to its incorporation policy, the Reserve Bank has chosen to focus on systemically important banks because they pose the greatest risk of causing significant damage to the financial system if they were to fail. It is worthwhile noting that although much of the debate regarding the policy has been around outsourcing to off-shore parents, the policy applies to outsourcing within New Zealand and to third parties.

6.9 The final policy is expected to be delivered by the Reserve Bank in September.

6.10 The policy is implemented by way of additional condition of registration. The proposed "condition of registration" relating to stand-alone capacity would read as follows, requiring:

> that the board of directors of the registered bank has legal and practical ability to control the management and operation of the New Zealand banking group's assets, liabilities and systems such that the bank may be operated on a stand-alone basis.
>
> For the purposes of this condition of registration, the term "systems" means all property, rights, controls, data and staff (including property, rights, controls, data and staff related to management, administrative and information technology functions, including any functions relating to any business of the bank that are carried on by a person other than the bank) owned, operated, or used by the bank.

6.11 The Reserve Bank has said it will to issue guidelines on the proposal to guide directors on complying with the outsourcing policy.

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[99] Ibid page 7 para 19.

[100] Ibid.

6.12 The draft policy is evident in the Conditions of Registration[101] of ANZ National Bank Limited which provide as follows:[102]

> "That no later than 31 December 2005 the Bank shall locate and continue to operate in New Zealand the whole of the Bank's domestic system[103] and the board of directors of the Bank will have unambiguous legal and practical ability to control the management and operation of the domestic system on a stand alone basis in, and resourced wholly within, New Zealand.
>
> That in respect of the international system[104] the board of directors of the Bank will, no later than 31 December 2005, have unambiguous legal and practical ability to control the management and operation of the international system on a stand alone basis."

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[101] Conditions of Registration, applicable as at 18 April 2005, ANZ National Bank Limited Group - General Disclosure Statement for the six months ended 31 March 2005.

[102] Ibid p.6.

[103] For the purposes of the conditions of registration, the term 'domestic system' means all property, assets and systems (including in particular (but without limitation) all management, administrative and information technology systems) owned, operated, or used by the Bank supporting, relating to, or connected with:

(a) the New Zealand dollar amounts and channels servicing the consumer banking market (but potentially also other customer segments); and

(b) the general ledger covering subsidiary ledgers for (a) above, together with a daily updated summary of the subsidiary ledgers running on the international system; and

(c) any other functions, operations or business of, or carried on by, the Bank (now or at any time in the future) that are not included in, or form part of, the international system.

[104] For the purposes of these conditions of registration the term 'international system' means those systems of the Bank generally having one or more of the following characteristics:

(a) supports foreign currency accounts/transactions;

(b) supports cross-border trade, payments and other transactions;

(c) supports businesses that operate in global markets;

(d) supports accounts and transactions undertaken by institutions, corporates and banks;

(e) used to manage large, volatile risk businesses which operate on a global basis;

(f) used to service customers who conduct accounts and transactions with the Bank in multiple countries;

(g) used by the non-Bank subsidiary companies.

Stand-Alone Capacity

6.13 The two broad functions identified by the Reserve Bank as being required for stand alone capability are:

(a) providing and circulating liquidity to the financial system;[105] and

(b) otherwise carrying on the business of the Bank.[106]

6.14 The Reserve Bank has said it will take a holistic approach when determining stand alone capability,[107] recognising that specific terms or concepts may not fit well with a particular bank's circumstances or business model and allowing the directors the flexibility to meet the Reserve Bank's desired outcome in a way that suits the bank's particular circumstances.[108] The key will be what is required by the expression operation "on a stand-alone basis".

6.15 What is clear from the Reserve Bank's commentary is that "The more material the system or function, the stronger the risk control and business continuity planning should be."[109]

6.16 In the context of the directors "ability to control", The Reserve Bank has identified two necessary categories of risk control to be held by directors. There are "legal ability to control" and "practical ability to control".[110]

6.17 "Legal ability to control" is described as "a function of all the aspects of law governing the bank's arrangements for the provision of functionality (whether outsourced or not). The focus is largely upon the continual robustness of contractual arrangements with third parties. Where a system is not owned by the bank or it is not located in New Zealand, the Reserve Bank expects directors to also consider:

- the types of events that would trigger the termination of the outsourcing contract;
- the enforceability of legal obligations under the contract;
- the effect of the statutory manager not being able to direct the service provider; and
- the effect of other foreign or domestic law that enabled actions not available to the Reserve Bank.[111]

6.18 "Practical ability to control" is the practical side of the legal ability. It requires that a statutory manager be able to exercise its legal ability to control quickly enough for the prevention of serious loss in the event of a failure.[112]

6.19 In addition to the Condition of Registration regarding stand-alone capacity identified above, the Reserve Bank also adds in its outsourcing policy that it

[105] Reserve Bank of New Zealand, *Reserve Bank of New Zealand Consultation Paper: Proposed Outsourcing Policy for Systemically Important Banks*, (October 2004), page 10.

[106] Ibid page 11 - 12.

[107] Ibid paras 24 - 26

[108] Ibid page 9.

[109] Ibid page 12 para 41.

[110] Ibid page 12 para 42.

[111] Ibid page 13-14.

[112] Ibid page 14.

considers its "overall stand-alone capability objectives would be promoted by conditions of registration on systemically important bank ensuring that certain basic features of governance consistent with stand-alone capability are in place in systemically important banks".[113] The additional conditions of registration proposed by the Reserve Bank are:[114]

(a) That the management of the bank by its chief executive officer or person in an equivalent position (together "CEO") shall be carried out solely under the direction and supervision of the board of directors of the bank;

(b) That the employment contract of the CEO of the bank shall be with the bank. The CEO's responsibilities shall be owed solely to the bank and the terms and conditions of the CEO's employment agreement shall be determined by, and any decision relating to the employment or termination of employment of the CEO shall be made by, the board of directors of the bank; and

(c) That all staff employed by the bank shall have their remuneration determined by (or under the delegated authority of) the board of directors or the CEO of the bank and are accountable (directly or indirectly) solely to the CEO of the bank."

The Conditions of Registration of ANZ National Bank substantially reflect these requirements.[115]

6.20 Concerns which have been raised with the outsourcing policy relate largely to the loss and efficiency gains and real costs of its implementation. ANZ National Bank Limited is reported as having announced a cost of $31m for expenditure relating to the exporting of critical storage and recovery systems from Australia to New Zealand as a result of the Reserve Bank's requirements for local oversight.[116]

6.21 The Reserve Bank itself has acknowledged that "outsourcing can have a positive impact on a bank's cost efficiency and exposure to certain risks, and can allow a bank to access specialist expertise that is not available, or would be expensive to maintain, internally."[117]

6.22 In its submission on the proposal, the New Zealand Business Roundtable ("**the Roundtable**") placed particular emphasis on s 68(a) and s 68(b) of the Act (discussed above). There has been very little case law on section 68[118] and no guidance has been offered by the courts on whether the Reserve Bank needs to balance subsections (a) and (b) when exercising its banking supervision and regulation powers. The drafters' use of the word "or" instead of "and" when linking subsections (a) and (b) could be interpreted to suggest the legislature

[113] Ibid page 16 para 59.

[114] Ibid page 16 para 59.

[115] Conditions of Registration, applicable as at 18 April 2005, ANZ National Bank Limited Group - General Disclosure Statement for the six months ended 31 March 2005.

[116] 'Westpac capitulates to NZ demands for local incorporation' http:// www.finextra.com, 16 December 2004.

[117] Reserve Bank of New Zealand Consultation Paper: Proposed Outsourcing Policy for Systemically Important Banks, October 2004, page 4 para 6.

[118] The only case that has considered section 68 is *Batkin Holdings Ltd v DFC Ventures Ltd* [1994] 1 NZLR 624, [1994] MCLR 57, (1993) 6 NZCLC 260, 274. In this case the High Court referred to the powers of the Reserve Bank relating to registration and prudential supervision found in s 68 to help to establish the 'purpose' of the Act when ruling on s 122.

did not intend a trade off between the two rather that the Reserve Bank can choose to pursue one objective ahead of the other.

6.23 The criticisms in the Roundtable's submission included:

- that the proposal will "impair banking efficiency by forcing them [major banks] to rely on possibly more costly and less expert in-house resources. If so it violates section 68(a)";[119]
- that "the proposal might violate s 68(b) by raising the likelihood of significant damages to the financial system as a result of the failure of a registered bank" as a "prudent owner of a New Zealand Bank might wish to guard against local management failure by ensuring that some operations were not fully under the control of the New Zealand managers";[120]
- the proposal forces "all New Zealand banks to rely on in-house resources, it may increase the exposure of the banking system to risks that are geographical in nature";[121]
- "the consultation paper does not address the issue of the trade-off between"[122] section 68(a) and section 68(b) and that as a result "it has not established that the proposal satisfies section 68";[123] and
- the proposal may impact the willingness of these and other overseas banks to invest in New Zealand.

6.24 In a report prepared for the Australian Bankers' Association ("**ABA**"), Boston Consulting Group ("**BCG**") echoed similar concerns regarding efficiency as highlighted in the Roundtable submission as well as assessing and attempting to quantify the possible cost impact of the Reserve Bank's draft policy. BCG concluded that "[The policy] would affect the efficiency of the New Zealand banking system, limit the range and sophistication of the products and services offered, and increase prices to customers."[124] The BCG estimated the impact of the policy would most likely be A$200-300m per annum including the following direct costs to the banking system:

- Reduced access to economies of scale and duplication of some corporate costs;
- Raising the cost of capital and reducing the capital available for growth;
- Reducing or slowing the development and deployment of product in the New Zealand market, in particular fewer specialised commercial products (pushing

[119] Letter from R L Kerr at the New Zealand Business Roundtable to Tim Ng at the Reserve Bank of New Zealand, *Comment on the Reserve Bank's Proposed Outsourcing Policy for Systematically Important Banks* ,28 February 2005, page 1.

[120] Ibid page 2.

[121] Ibid page 2.

[122] Ibid page 2.

[123] Ibid page 2.

[124] Letter from Boston Consulting Group to ABA, *Impact of NZ prudential regulations on the Long-Term Efficient Operation of Australian Subsidiaries Operating in New Zealand,* 27 February 2005, page 7.

New Zealand corporations to purchase them in the Australian market or elsewhere).[125]

6.25 David Tripe of Massey University has publicly criticised the BCG report saying the cost estimate seems "unbelievable"[126] and "the argument they put forward in relation to economies of scale bears no relationship to any academic literature" of which he is aware.[127] Whether or not these large numbers are accurate, the implementation of the draft policy will undoubtedly be time-consuming and expensive for the Big Four Banks.

6.26 We also understand that there are a number of submissions on the outsourcing policy which are not publicly available due to their commercially sensitive nature. Accordingly, it remains to be seen whether the Reserve Bank's proposal will be implemented in its current form.

7. Conclusion

The recent developments in the area of prudential regulation are largely a response to Reserve Bank concerns as a result of the concentration of ownership of New Zealand's systemically important bank ownership in Australia. Despite, professed greater co-operation with APRA, banks face significant costs in implementing policies of separateness, particularly in relation to outsourcing and local incorporation. It remains to be seen if the same will be the case in relation to Basel II implementation. At this stage it seems there is a considerable way to go to achieving Tasman-harmonisation in this area when so many policies are premised on maintaining separation.

[125] Ibid page 2.

[126] 'Bank owners go on defensive', *The New Zealand Herald* (Auckland New Zealand) 1 April 2005, Business, general.

[127] 'Ibid.