



**Reserve Bank of New Zealand Consultation Paper:**

**Proposed Outsourcing Policy for  
Systemically Important Banks**

**October 2004**

## **CONSULTATION**

The Reserve Bank welcomes comments on its proposed outsourcing policy for systemically important banks, which is set out and discussed in this paper. The paper is also available on the Reserve Bank's website at [www.rbnz.govt.nz](http://www.rbnz.govt.nz).

Comments on the proposed policy should be addressed to:

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Please send comments by 31 January 2005.

## A. INTRODUCTION

1. This paper discusses the Reserve Bank of New Zealand's proposed policy on outsourcing by systemically important banks (those whose New Zealand liabilities net of amounts due to related parties exceed NZ\$10 billion) registered under the Reserve Bank of New Zealand Act 1989 (the Act). We focus on systemically important banks at this stage because they present the greatest risk of causing significant damage to the financial system if they were to fail.
2. We note that systemically important banks are required to be incorporated in New Zealand under the Reserve Bank's local incorporation policy. Currently, one systemically important bank operates as a branch in New Zealand and we are working with that bank to see how it can comply with the local incorporation policy. The proposed outsourcing policy would apply to all systemically important banks irrespective of whether they are operating in New Zealand as subsidiaries or as branches. In the case of a branch bank where the New Zealand business receives services from other parts of the same legal entity, appropriate changes would need to be made to the legal instruments discussed here in order to cater for such in-substance outsourcing by the New Zealand business.
3. For the purposes of the proposed policy, outsourcing arrangements include any arrangements falling within the meaning of section 78(fb) of the Act (*mutatis mutandis* for any arrangements between a New Zealand branch bank and other parts of the same legal entity), which reads as follows:

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.
4. Section B of the paper discusses the potential costs, benefits and risks of outsourcing; why financial regulators in a growing number of jurisdictions are interested in the outsourcing activities of banks and other financial firms, and the concerns the Reserve Bank sees pertaining to New Zealand's circumstances. Section C sets out the proposed outsourcing policy and discusses a model condition of registration on systemically important banks that we are considering as the main mechanism by which the proposed outsourcing policy would be implemented. Section D discusses conditions of registration relating to governance and management of systemically important banks that we believe would bolster the effectiveness of the model condition of registration discussed in Section C. Section E discusses the monitoring and compliance mechanisms we have in mind to support the proposed outsourcing policy.
5. After considering comments on the proposed policy, we will consult with banks on any proposed new or amended conditions of registration, amendments to the *Statement of Principles: Bank Registration and Supervision*, or other guidance documents we see as necessary, based on the discussion in the paper and the comments received.

## **B. BENEFITS AND COSTS OF OUTSOURCING**

### **B.1. Outsourcing by financial firms and foreign regulators' responses**

6. Around the world, banks, other financial firms, and indeed a range of non-financial firms have pursued, entered into and maintained outsourcing arrangements for some time, and the use of outsourcing continues to grow. Firms may choose to outsource certain activities for a variety of reasons. Outsourcing can have a positive impact on a firm's cost efficiency and exposure to certain risks, and can allow a firm to access specialist expertise that is not available, or would be expensive to maintain, internally.
7. The opportunities for outsourcing in information-rich industries such as banking have increased markedly in recent years as communications and information technology have evolved and improved. More and more activities that were traditionally conducted in-house by banks are now candidates for commercially-viable outsourcing to specialist providers. At the same time, the increasing spread of major banks' operations across multiple legal entities and jurisdictions has led those banks to pursue opportunities to achieve efficiencies by centralising and consolidating a range of internal functions, either within a parent operating bank that provides those functions as business services to its subsidiaries, or within an entity set up to specialise in a particular function (such as a call centre). This phenomenon of outsourcing to parent banks is particularly relevant to the New Zealand banking system, which is dominated by banks owned by relatively large, foreign-based parent banks.
8. Notwithstanding that outsourcing can allow banks to capture cost efficiencies, outsourcing can also expose banks to particular kinds of risk, and to the extent that these risks are not managed adequately, they may be matters of regulatory concern. Salient issues in this context include:
  - ***Vulnerability to failure of service providers.*** A bank that relies heavily on a single service provider for a mission-critical service is vulnerable to the failure of that service provider, if the service cannot quickly be provided by an alternative provider. If a number of banks are dependent on the same provider, the banking system as a whole may be exposed to the risk of failure of a single provider to a rather greater extent than any single bank may appreciate.
  - ***Manageability of operational risk.*** Operational risk associated with a bank's internal processes may be easier to assess and manage than operational risk associated with a service provider's processes, to the extent that the full internal control apparatus is available to a bank to assess its own processes,

but cannot be brought to bear in the same way on those of its service provider.

- **Manageability of legal risk.** Similarly, risk associated with a bank's legal ability to control functions may be greater where functions and processes are outsourced. In addition, banks remain responsible for the confidentiality of information about their customers and may have other legal obligations in respect of the use of customer information, and may thus be exposed to breaches of those obligations caused by their service provider's treatment of the information.
9. These issues would be expected to be rather important for a bank concerned to maintain its own viability. The bank would therefore generally have incentives to take due care to manage them appropriately, through contractual terms and the maintenance of good relationships, when entering into outsourcing arrangements with unrelated-party service providers. Where a service provider is a related party, however, the incentives to manage outsourcing risks may be blunted, to the extent that the corporate group of which the bank is a member behaves as a single corporate entity, and the bank does not adequately consider and address the possibility of failure of other members of its group when entering into and managing its outsourcing arrangements.
  10. As a result of the increase in the prevalence and scope of outsourcing activity by financial firms, financial regulators in many jurisdictions – including Australia, Canada, Hong Kong, Singapore, the UK, the US, and Japan, among others – have focused recently on the implications of outsourcing both for the risk positions of individual institutions and for the stability of the wider financial system, and released prudential guidance on outsourcing for institutions within their jurisdictions.<sup>1</sup>
  11. A number of common themes emerge from the prudential guidance issued by foreign bank regulators:
    - that regulators must be kept informed of “material” outsourcing plans, where “materiality” is to be determined by the outsourcing bank through a credible internal assessment process – recognising that materiality is often subjective and dependent on a particular bank's circumstances;
    - that outsourcing arrangements must not prevent the bank from fulfilling its obligations to customers and meeting regulatory requirements, including requirements regarding the ability of supervisors to access bank and customer information in a timely manner;

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<sup>1</sup> The Joint Forum, an international group of banking, securities and insurance regulators, recently released a useful survey of national outsourcing policies – see Joint Forum (2004) *Outsourcing in Financial Services*, available at [www.bis.org](http://www.bis.org).

- that these obligations and regulatory requirements remain the responsibility of the directors of the bank; and
- that the bank must adequately manage outsourcing arrangements through explicit service-level and pricing agreements with its providers, and through business continuity planning – with appropriate testing – against the risk of provider disruption or failure.

## **B.2. New Zealand's circumstances**

12. Many of the issues identified by foreign regulators are relevant to the New Zealand banking system and to the design of effective regulatory oversight of the outsourcing activities of New Zealand banks. In the policy proposed here, we pick up on a number of these issues and themes, although, of course, the proposed policy is intended overall to cater specifically for the circumstances and characteristics of the New Zealand banking system. The proposed policy is also intended to align with the Reserve Bank's supervisory framework and our current priorities within that framework.
13. In New Zealand, the domination of the banking system by banks owned by foreign parent banks means that the extent of outsourcing to offshore parent banks is much greater here than in most other countries. All of New Zealand's systemically important banks are currently owned by large parent banks incorporated in a single foreign jurisdiction (Australia). The New Zealand banks in these corporate groups maintain, to varying extents, outsourcing arrangements with their parent banks, for the performance of a range of functions such as credit assessment, internal audit, accounting and data processing, IT management and risk management. In addition, some New Zealand banks have outsourced functions such as data processing to unrelated parties.
14. The depth to which outsourcing activities appear to be pursued by systemically important banks in New Zealand, and the apparent trend towards further centralisation of New Zealand banking operations within parent banks, has led the Reserve Bank to ask the questions (a) whether this centralisation process may undermine the Reserve Bank's ability to manage financial distress in New Zealand, and (b) whether the directors and management of New Zealand banks are ensuring that outsourcing arrangements entered into by their banks are managed in the New Zealand banks' best interests (the soundness of individual institutions being relevant to the soundness of the financial system as a whole), especially in view of the high degree of related-party outsourcing that exists.
15. The concern underlying question (a) would be if outsourcing and centralisation arrangements were to place out of legal or practical control the functionality the Reserve Bank would need to access in a distress situation, or to otherwise inhibit the Reserve Bank's ability, through a New Zealand statutory manager, quickly to

take control of a distressed bank and ensure that the New Zealand financial system continues to function.

16. The concern underlying question (b) would be if a bank outsourcing to a related party were not to approach the arrangement on a substantially similar commercial basis as it would for an arrangement with an unrelated party, creating the risk of over-reliance on the related party “always being there” to provide service. In related-party arrangements where the provider is itself a financial institution, there is the additional concern that stress at the provider might quickly cause stress at the bank too, if there is a public perception (rightly or wrongly) that the cause of the stress is common to both financial institutions.
17. The following section discusses our proposed outsourcing policy intended to address these concerns and issues.

### **C. OUTSOURCING POLICY PROPOSALS**

18. Section 68 of the Act requires the Reserve Bank to exercise its banking supervision and regulation powers 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.
19. Our outsourcing policy proposals are intended to pursue these objectives 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 in the face of the failure of a service provider; and
  - (d) to capture any efficiency, cost and risk-reduction advantages that outsourcing may provide, subject to objectives (a), (b) and (c) being met.

### **C.1. Model condition of registration – “stand-alone” capability**

20. Objectives (a), (b) and (c) in paragraph 19 capture the essence of what we mean by “stand-alone capability”. We view stand-alone capability as a key part of a bank’s ability to carry on its business in a prudent manner, and outsourcing as an important influence on stand-alone capability. In this context, we note that the Act specifies, in section 78(1)(e), that

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

is relevant to “carrying on business in a prudent manner”.

21. We believe that our stand-alone capability objectives would be effectively promoted in the context of outsourcing by a condition of registration on systemically important banks that 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.

For the purposes of this condition of registration, the term “may be operated on a stand-alone basis” is defined in the Reserve Bank of New Zealand document entitled “Outsourcing Guidelines”.

22. We have designed this model condition with the following features in mind. The model condition:
- focuses on the outcome in which we are interested – stand-alone capability;
  - refers to a guideline document, that would elaborate on the meaning of the key concept of “stand-alone” capability and on the implications for stand-alone capability of outsourcing (substantially based on the discussion in this section);
  - holds the directors of the bank responsible for ensuring stand-alone capability;
  - explicitly requires both legal and practical control of the bank’s systems sufficient for stand-alone capability;
  - requires directors to contemplate all of a bank’s systems, including outsourced systems, when assessing how they might meet the requirement of stand-alone capability; and
  - requires the term “systems” to be interpreted broadly.

23. The condition would be altered as necessary for application to the circumstances of non-locally incorporated banks.
24. The model condition's coverage of all bank functions and systems, not just those that are outsourced, recognises that banks' outsourcing strategies will typically and quite reasonably be formulated and implemented within an overall holistic strategy for the provision and management of all the bank's functionality. In such a holistic strategy, outsourced systems and functions may be significantly integrated with in-house systems and functions. The model condition would therefore require a similarly holistic approach to the stand-alone capability requirement.
25. The model condition of registration, quite deliberately, does not categorise or name particular systems or functions for the purposes of the proposed policy, and avoids referring to specific terms or concepts that may not fit well with a particular bank's circumstances or business model.
26. We believe that this approach is consistent with our emphasis on the role of a bank's directors in ensuring that the bank is managed prudently and effectively. The approach is intended to allow the directors flexibility to meet our required outcome in a way that suits, in the directors' judgement, the particular circumstances and business model of the bank. The intent of providing this flexibility is to ensure that financial system efficiency is not constrained unduly by our proposed policy.
27. Having said this, the Reserve Bank recognises that some further elaboration about the outcome sought may be useful to directors, which is why the model condition refers to a guidance document. We would propose to issue such a guidance document based on the discussion in this section, intended to assist directors in formulating their strategies for compliance with the stand-alone capability requirement. The purposes of the guidance document and other issues of compliance monitoring and assessment are discussed further in Section E.
28. The objectives set out in paragraph 19 identify two broad functions for which a bank's directors would need to ensure stand-alone capability:
  - (1) providing and circulating liquidity to the financial system; and
  - (2) otherwise carrying on the business of the bank.
29. Under the model condition, the presumption would be that a given bank system would be necessary for stand-alone capability to perform either or both of the two functions, unless the directors are able to establish a good case why legal and practical control of the system is not required for that purpose. We now discuss these two functions in more detail.

**C.2. Systems and functions for the purpose of continuing to provide and circulate liquidity to the financial system and economy under statutory management**

30. The continued provision and circulation of liquidity in the New Zealand financial system would be a top-priority objective of the Reserve Bank in the first stages of managing the financial distress or failure of a systemically important bank. We do not believe a systemically important bank could be allowed to cease operating for any substantial length of time (more than, say, a period of time that would cross a value date), because of the large-scale disruption to the financial system that the resulting sharp contraction of liquidity and failures to settle that prolonged closure would cause.
31. A statutory manager of a failed bank would, therefore, very probably be directed by the Reserve Bank immediately to restore the bank's operations such that:
- (a) the bank is able to continue to meet its daily settlement and other time-critical obligations, so as to avoid disruption and damage to the rest of the financial system;
  - (b) the statutory manager is able to understand and cover the bank's credit and market risk positions, thereby limiting further damage to the bank's balance sheet;
  - (c) the statutory manager has at hand the systems and balance-sheet data necessary for the New Zealand authorities to have available on the day of the failure a range of options for managing the failed bank; and
  - (d) the bank is able to provide basic services to existing customers, including liquidity – crucially, access to deposits and credit lines – and account-activity reporting.
32. Because of the time-criticality of these functions and the escalating damage to the financial system that their absence or dysfunction would be likely to cause, we would see it as essential for the statutory manager to be able to restore these operations within hours – certainly the first one or two value days – after the failure. Within this period the statutory manager would have to prioritise the restoration of certain functions before others. For example, daily settlement processes would need to be restored within the same value day, in order to avoid a failure to settle that could cause financial distress more widely, including to other financial institutions. Transactions to manage risk might follow on the next value day, if there were not the time to begin that process on the day of the failure.
33. Every failure situation will be different, and the statutory manager's prioritisation would depend to some degree on the circumstances of the bank and of the failure (such as time of day or week). However, there is probably a basic sequence of events and required actions that would be common to most failure and statutory

management situations involving a systemically important bank. The Appendix provides an example of such a sequence to illustrate the Reserve Bank's thinking on this matter.

34. The sequence of required actions that would be relevant for a particular bank would heavily influence the bank systems that would be viewed as necessary for the function of liquidity provision and circulation. We consider it very likely that this set of systems will include those supporting a significant part of a bank's transactional data processing, balance sheet management and risk reporting, clearing and settlement and liquidity management, and wholesale funding.
35. Under the proposed policy, any outsourcing of those systems would have to be extremely robustly controlled in terms of the legal and practical ability of the directors (in whose place a statutory manager would be acting in a failure situation) to control the systems and the functions they support. Such systems would most likely be vital to the bank's viability in the normal course, and therefore subject to the highest standards of risk control in any case.

**C.3. Functions and systems for the purpose of carrying on the business of the bank**

36. Identifying bank systems that are necessary for carrying on the business of the bank (but not for continuing to provide and circulate liquidity to the financial system), either in the face of the failure of a service provider or under new ownership of the bank, would probably be a fairly subjective exercise. We suspect that what would be needed to carry on the business of a particular bank would depend on that bank's business model and strategy regarding such things as product mix.
37. Our interest in a bank's ability to carry on business after a failure stems from our desire for there to be a range of viable strategies available to the authorities for exit from statutory management. Such exit may include continued operation of the bank by the Government, a sale of all or part of the bank to new owners, or a liquidation of the bank in a manner that is orderly and efficient, and that recognises, to the extent possible, the prior expectations of customers regarding the liquidity of their claims.
38. As discussed in section C.1, we propose a general approach to the issue of systems necessary for the bank to carry on business as a bank. As noted above, the model condition presumes that all of the bank's systems are potentially necessary for it to carry on business as a bank – consistent with our reluctance to second-guess what a "bank" is, beyond the purpose of providing and circulating liquidity to the financial system. The bank's directors would need to determine through a credible internal process that certain systems are not necessary for the function of carrying on business as a bank, in order to exclude those systems from the ambit of the model condition.

39. The Reserve Bank would expect that such an internal assessment process of the “materiality” of a given system or function for the bank’s ability to carry on business would include consideration of factors such as the following, under a scenario in which the system or function suddenly became unavailable<sup>2</sup>:
- (a) the ability of customers to find substitutes (e.g. other banks) for products supported by the system or function, or to use a “work around” if the products suddenly became unavailable;
  - (b) the extent of inconvenience to customers;
  - (c) the number of customers affected;
  - (d) the visibility of the unavailability of products supported by the system or function;
  - (e) the impact on the ability of the bank to provide basic banking products, including taking deposits and other funding, and managing credit extended to customers; and
  - (f) the impact on the ability of the bank to meet regulatory, code-of-conduct and legal obligations.
40. Obviously, these factors should be relevant to a bank’s management generally, whether or not the systems and functions are provided in-house or are outsourced. If a system or function is outsourced, an additional factor to consider for the purposes of materiality for ability to carry on business would be the scope to arrange quickly for the system or function to be provided in some alternative manner.
41. Directors would generally be expected to ensure a degree of risk control and business continuity planning around particular systems and functions commensurate with their assessed materiality against criteria such as those above. The more material the system or function, the stronger the risk control and business continuity planning should be.
42. The aspect of risk management in which the Reserve Bank is particularly interested for the purposes of the proposed policy is the directors’ “ability to control” those systems and functions. The model condition of registration would require both “legal ability to control” and “practical ability to control”. We discuss these two concepts in turn.

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<sup>2</sup> We note that other regulators have promulgated similar guidance for the kinds of factors that regulated entities under their jurisdiction should have regard to in managing risks that may arise from outsourcing – see Joint Forum (2004) *Outsourcing in Financial Services*, available at [www.bis.org](http://www.bis.org).

#### **C.4. “Legal ability to control”**

43. The directors’ “legal ability to control” is vital to their ability to ensure the continued delivery of services under conditions of stress. Stress circumstances are particularly significant for the present purposes, since it is under these conditions that the willingness of the parties to an outsourcing arrangement to continue to perform in the interests of preserving an ongoing relationship would be most under question. This may be especially true in related-party arrangements, where the assumption of an ongoing relationship will be very strong in good times, perhaps leading to less-than-adequate care by the parties to ensure their respective positions are protected for times of stress, when the relationship may be strained or broken. It is under these conditions that the New Zealand bank will have to rely heavily on its legal ability to control systems needed to operate on a stand-alone basis, because the provider’s economic incentives associated with the prospect of an ongoing, mutually advantageous commercial relationship may be weak.
44. In an extreme case, the stress affecting one or both parties may be so severe that one or both parties is in statutory management. In the case of the service provider being in statutory management, the directors’ legal ability to control systems such that the bank can be operated on a stand-alone basis will need to be robust to the actions of the provider’s statutory manager, whose obligations and duties may directly conflict with the best interests of the New Zealand bank (especially if the service provider is itself a financial institution). In the case of the New Zealand bank itself being in statutory management and subject to the Reserve Bank’s directions, our interest would be in the statutory manager, who would assume the powers of the directors, having legal ability to control the bank’s systems such that the bank may be operated on a stand-alone basis in order to achieve the outcomes discussed in sections C.2 and C.3.
45. Generally speaking, legal ability to control is a function of all the aspects of law governing the bank’s arrangements for the provision of functionality (whether outsourced or not). Relevant contracts for stand-alone capability would include service and employment contracts, contracts pertaining to ownership rights and licenses over fixed assets and intellectual property, and arrangements such as codes of conduct where these are legally enforceable.
46. The contracts will themselves be governed by some combination of New Zealand law and foreign law, depending on the domicile of the parties to the arrangements, the contractual terms, and potentially the location of the systems themselves. These things may determine the courts to which recourse would be available in case of dispute.
47. Where a system is not owned by the bank, or the system is located outside New Zealand, or the bank is not incorporated in New Zealand, salient risks the Reserve Bank would expect directors to address would include, for example:

- (a) service contracts terminating upon certain events occurring (such as insolvency of one of the parties);
- (b) enforceability of legal obligations in terms of both certainty and timeliness;
- (c) a service provider not being subject to the direction of the statutory manager – including if the provider (or the arrangement with the provider) is subject to foreign law and foreign courts which may not recognise the directions of the directors, or those of the statutory manager; or
- (d) foreign or domestic law empowering certain parties (such as regulators other than the Reserve Bank) to take action in respect of the arrangements or the systems under certain circumstances, such as statutory management.

#### **C.5. “Practical ability to control”**

48. Legal ability to control relevant bank systems and functions, while necessary, is not sufficient for stand-alone capability in the circumstances we have uppermost in mind. The objective of avoiding significant damage to the financial system that could be caused by the failure of a registered bank requires, in our view, that the Reserve Bank (through a statutory manager) be able to continue to operate a failed systemically important bank for the purposes of providing and circulating liquidity to the rest of the financial system and the economy, and to have available a range of options for the conduct of, and exit from, statutory management.
49. These processes will require *speed*. Legal ability to control an outsourced system will be insufficient if the practical ability to control in a timely manner, such that a failure management timeline like that set out in the Appendix can be achieved, is absent. (Deficiencies in the legal ability to control, such as legal uncertainty that might require litigation to resolve, could of course also generate unhelpful delays, in the event.)
50. The relevant delay for the purposes of practical ability to control an outsourced system or function would be that required to re-establish the provision of the system or function, after the failure either of the provider or of the bank itself. We are interested not only in the expected delay under a range of scenarios, but also in the risks around any delay to the restoration of function. Both the expected delay and the risks would be affected by a number of characteristics of the outsourcing arrangement and the risk mitigants that the bank has placed around it.
51. The availability and responsiveness to the directors or to the statutory manager of key staff to operate and service outsourced systems will obviously be crucial. For the failure management scenarios the Reserve Bank has in mind, key staff will potentially (depending on the organisational structure of the bank) include a range

of staff from various areas of the bank's operations, including technical IT support and data processing staff, "back-office", "middle office" and "front office" staff, and managerial staff, depending on the task to be performed.

52. The availability and responsiveness of staff may also be influenced by physical location and the remoteness of operations, to the extent that those factors affect communications and other logistics involved in managing a stress situation.

**C.6. Measures to improve legal and practical ability to control, and ensuring continued service provision in outsourcing arrangements**

53. We note that there may be a number of measures that banks may take to improve their legal and practical ability to control systems needed to operate on a stand-alone basis, even if the services supported by those systems are provided by another party. The key consideration for the Reserve Bank is the effectiveness of these measures in terms of stand-alone capability and the objectives discussed here. We would expect that banks would contemplate such measures in any case for outsourcing arrangements whose continued reliable operation, in the face of provider disruption or failure, would be necessary for the bank's viability in the normal course.
54. At the very least, a bank would be expected to put in place explicit (commercially reasonable) contractual terms and conditions that make it commercially worthwhile for the service provider to continue to perform in the face of stress either at the provider or at the bank itself. Such terms could include provisions requiring certain levels of disaster-recovery and business-continuity planning. Continued provision in the face of stress would be an important measure in ensuring that the bank could continue to operate in the interim, perhaps while processes were invoked to bring the systems or functions back in-house if that were necessary.
55. In circumstances where the service provider is an independent party, one would expect the service provider itself to ensure that its own position was protected through commercially acceptable terms and conditions around continued supply and continued payment. However, as discussed earlier, banks outsourcing to related parties may need to pay particular attention to this aspect, to the extent that a tendency for the group to behave as a single commercial entity may blunt the incentive to document fully service levels and pricing schedules on a commercially "arms-length" basis.

**D. PROPOSED CONDITIONS OF REGISTRATION ON MANAGEMENT REPORTING LINES**

56. The Reserve Bank views governance and management as bank functions that have a key influence on stand-alone capability, a view that is reflected in the broad

definition of bank “systems” in the model condition set out in the previous section<sup>3</sup>. We believe that the responsiveness of staff in a stress situation would be heavily dependent on the quality of day-to-day working relationships between the directors and senior management of the New Zealand bank, between the senior management and the staff, and, where relevant, between the staff of the bank and the staff of service providers. The quality of these working relationships is in turn dependent on the quality of governance within the bank, including the operative lines of responsibility and accountability.

57. Where arrangements with related parties involve “outsourcing” of governance and management functions to those parties, the commercial drive for efficiencies in the management of the overall corporate group might promote the creation of management structures that see the corporate group being run as essentially a single entity (for example, via some form of matrix reporting to the heads of functions in the global banking group, with only “dotted line” reporting to New Zealand bank executives), to the point that the stand-alone capability of the New Zealand bank is undermined. We believe that, to ensure the consistency of internal governance and management structures with stand-alone capability, systemically important banks’ boards of directors must exercise the power to employ and dismiss the bank’s chief executive and to determine the chief executive’s terms of employment. The accountabilities of the staff of the bank would also need to be primarily to the chief executive of the bank.
58. If a parent bank were to hold these powers over the chief executive’s employment, the chief executive would be primarily accountable to the parent company rather than to the local board. This would inhibit, in our view, the New Zealand board’s ability to direct and oversee the management of the bank and to modify the parent’s policies where the interests of the local bank might require doing so.
59. We believe our overall stand-alone capability objectives would be promoted by conditions of registration on systemically important banks ensuring that certain basic features of governance consistent with stand-alone capability are in place in systemically important banks. The conditions of registration would require:
  - (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

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<sup>3</sup> The Bank has increasingly been focusing on features of bank governance that would contribute to our objectives of soundness and efficiency and avoiding significant damage that could arise from a failure. For example, the Bank introduced on 1 July 2004 a condition of registration requiring that bank directors and senior managers be suitable for their positions, in terms of certain basic checks for competence and integrity. This condition of registration applies to all executives of a locally incorporated bank who report directly to the chief executive.

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.

- 60. These conditions would bolster, in respect of reporting and accountability, the more general model condition set out in section C.1. requiring directors to ensure stand-alone capability. The overall intention would be to ensure that the board and executives of systemically important registered banks have meaningful rights, ability, and incentives to manage the New Zealand bank on an ongoing basis in its own best interests, and also so that under stress or failure management circumstances, the directors or a statutory manager will have unfettered legal and practical access to key staff and thereby the ability to manage the New Zealand bank through its difficulties.
- 61. It is not our intention for the suggested reporting and accountability requirements to preclude or inhibit effective working relationships between a bank's staff and their parent-bank counterparts (or between the staff and staff of service providers). We are aware that such working relationships exist to some extent currently and have the potential to improve efficiency and risk management in the New Zealand financial system, through the adoption of best practices developed by the parent bank, and through harmonisation of processes across the group. We wish to ensure, though, that any such working relationships do not undermine the legal and practical capability of a bank's board and executives to test parent-bank policies for their appropriateness for New Zealand circumstances, and, in light of those tests, to modify the policies if necessary for their application in New Zealand. The Reserve Bank views such testing and review by the New Zealand directors and management as an important part of stand-alone capability.

## **E. COMPLIANCE MONITORING AND ASSURANCE**

### **E.1. Director attestations and disclosure**

- 62. Our general approach to monitoring and assuring compliance with conditions of registration – requiring director attestations and disclosure – would also be applied to the conditions of registration suggested here. Directors are already required to attest that their bank has systems in place to adequately monitor and control the bank's material business risks (which would be expected to include risks relating to material outsourcing arrangements) and that those systems are properly applied. The additional content to the attestations introduced by the conditions suggested here would be in regards to compliance with the stand-alone capability and

governance requirements. The conditions of registration and directors' attestations regarding compliance would be required to be published in the bank's disclosure statements and audited along with other information in the statements, in the same manner as for existing conditions of registration.

63. The model condition set out in section C is, as noted, deliberately very general, to allow directors and banks flexibility to comply with the stand-alone capability requirement in a way that best fits with their particular circumstances. The guidance note referred to by the model condition would be intended to give directors guidance on our intentions regarding interpretation and operationalisation of the model condition, and specifically about the meaning of the term "may be operated on a stand-alone basis" in this context.
64. Given the technical complexity of some of the judgements directors would be required to make in order to satisfy themselves that they are meeting the stand-alone capability requirement, the Reserve Bank would expect directors to avail themselves of expert technical advice on their bank's stand-alone capability position. This would especially be true in circumstances where a bank is contemplating making major changes to its outsourcing arrangements, to ensure that the changes were carried out in a way that did not compromise stand-alone capability.

## **E.2. Reserve Bank engagement with systemically important banks**

65. The outsourcing policy proposed here would establish a major plank in the Reserve Bank's failure management framework, which we have been developing for some time. Given the importance of the stand-alone capability objective to that framework, we would expect to engage closely with banks for the purposes of assuring compliance with the policy. In areas where director attestation and disclosure might not be sufficient to provide the degree of assurance of stand-alone capability we are seeking, we would expect to bolster those measures with the use of our powers under section 95 of the Act to require a bank to obtain an independent report on the bank's outsourcing arrangements, prepared by a person approved by the Reserve Bank, against a terms of reference based on the issues discussed above. Such an independent report would be at the bank's cost. The report could assist in the directors' assessment of the consistency of the bank's outsourcing arrangements or plans with stand-alone capability, and would provide us with additional assurance about the bank's compliance with our requirements.
66. We would also expect to be kept apprised of any material outsourcing initiatives or changes systemically important banks might be planning, in light of the thinking set out in the proposed guidance note. Banks should be expected to consult with us if clarity on these matters is needed.

## APPENDIX

### Example sequence of events and required actions immediately following a failure

The following example timeline sets out key events and required actions that a statutory manager would have to take in the immediate aftermath of a systemically important bank failure, in order to contain damage to the financial system. Under the proposed policy, the statutory manager would need to have timely and unfettered control of all bank systems, processes and staff necessary to meet the objectives set out here. The particular systems, processes and staff needed would be likely to vary from bank to bank.

Time	Event	Required action
<b>Day 1</b>	<ul style="list-style-type: none"> <li>➤ bank fails</li> <li>➤ statutory manager appointed</li> </ul>	<ul style="list-style-type: none"> <li>➤ close doors and freeze accounts</li> <li>➤ de-authorise queued payments in RTGS switches</li> <li>➤ determine or confirm losses and solvency position, including:               <ul style="list-style-type: none"> <li>• composition and value of assets including impaired and unimpaired</li> <li>• composition and value of liabilities</li> <li>• composition and value of derivative positions</li> <li>• composition and value of uncommitted funds</li> </ul> </li> <li>➤ distribute losses – for example, haircut creditors</li> <li>➤ assess credit facilities and withdraw lines to doubtful credits</li> <li>➤ restore account access to (possibly haircut) depositors and credit facilities to approved counterparties</li> </ul>
<b>End of Day 1 (banking day)</b>	<ul style="list-style-type: none"> <li>➤ RBNZ liquidity support</li> </ul>	<ul style="list-style-type: none"> <li>➤ determine the need for emergency liquidity support from the Reserve Bank</li> <li>➤ re-submit payments to RTGS switches</li> <li>➤ clear and settle outstanding batch-processed payments</li> </ul>
<b>Start Day 2</b>		<ul style="list-style-type: none"> <li>➤ recalculate balance sheet (accounting for transactions, revaluations) and risk reporting for position as at end of previous day</li> <li>➤ enter into new hedge contracts to manage new risk position of bank</li> <li>➤ maintain basic services (e.g. liquidity and account activity reporting) to existing clients</li> </ul>
<b>Day 3 onwards</b>	<ul style="list-style-type: none"> <li>➤ strategy for exit from statutory management chosen by authorities</li> </ul>	<ul style="list-style-type: none"> <li>➤ as for Day 2 plus:</li> <li>➤ begin restoring less critical functions not restored on re-opening the bank, as necessary given chosen exit strategy</li> </ul>