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# The Reserve Bank's local-incorporation policy

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Foreign-owned banks play an important role in New Zealand's financial system. This article discusses the Reserve Bank's local-incorporation policy, which is one of the key elements in the policy framework to minimise the risks and maximise the benefits of hosting foreign-owned banks. The article identifies some of the benefits and risks of hosting foreign-owned banks; it discusses the local-incorporation policy rules and how the policy fits into the wider set of rules affecting banks; and discusses how the policy promotes the soundness and efficiency of New Zealand's financial system, and avoids the damage to the financial system that could arise from the failure of a foreign-owned bank.

## 1 Introduction

Banks play a major role in New Zealand's financial system, mobilising the economy's resources and providing transactional services for customers at both retail and wholesale levels. Consequently, the soundness and efficiency of our financial system as a whole depend importantly on the prudent and efficient operation of banks.

Foreign-owned banks account for around 98 percent of assets in the New Zealand banking system, and their performance is clearly important to the soundness and efficiency of our financial system.<sup>1</sup> Against that background, several of the Reserve Bank's recent policy developments have sought to maximise the benefits of hosting foreign-owned banks while minimising the risks. The local-incorporation policy has been one such initiative, and is the topic of this article. Section 2 of the article discusses the benefits and risks arising from foreign ownership. Section 3 provides details about the content and requirements of the policy. Section 4 discusses the costs and benefits of the policy itself. Box 1 provides a brief history of the policy's development and implementation, including an outline of the events that led to Westpac's establishment of a locally incorporated bank in New Zealand. Section 5 concludes.

Part V of the Reserve Bank of New Zealand Act 1989 (the Act) gives the Reserve Bank of New Zealand its powers to register banks and perform prudential supervision of banks.

Section 68 of the Act states that those powers must be used 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.

To pursue those purposes, the Reserve Bank's supervisory regime comprises three pillars: market discipline, which involves creditors and financial markets monitoring banks; self-discipline, which involves banks and their decision makers responding to incentives to operate prudently and efficiently; and regulatory discipline, which comprises prudential rules set by the Reserve Bank. The regime's focus lies particularly on the first two of those pillars, consistent with the Reserve Bank's experience that market-based solutions, supplemented by regulatory prompting where appropriate, are often the best way of pursuing the section 68 objectives.<sup>2</sup>

New Zealand's banking system is heavily foreign-owned even when seen against the worldwide trend towards increased cross-border banking. Moreover, ownership of New Zealand's banks is concentrated heavily in one country: Australia. Australian-owned banks account for around 90 percent of assets held in our banking system. Further, each of New Zealand's four largest banks comprises a significant proportion of the global operations of their Australian-

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<sup>1</sup> In this article, the statistics on the composition of the New Zealand banking system refer to the situation as at 30 June 2006.

<sup>2</sup> Bollard (2005) summarises the nature of the three-pillar regime.

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incorporated owners.<sup>3</sup>

Foreign ownership therefore acts as a channel through which distress from abroad could spread to New Zealand. It also creates a risk that New Zealand banks might not always have the ability or incentives to act in ways consistent with promoting a robust and efficient New Zealand financial system. At the same time, foreign ownership can provide benefits in a number of ways. These risks and benefits are discussed in section 2 of this article.

The local-incorporation policy helps to maximise the rewards and limit the potential risks of having foreign-owned banks operating in New Zealand. It requires that foreign-owned banks with certain characteristics (outlined in section 3) must incorporate in New Zealand if they wish to operate in New Zealand.<sup>4</sup>

By means explained in this article, the local-incorporation policy helps to provide clarity and certainty about the financial position and operational robustness of the large, foreign-owned banks operating in New Zealand. It also promotes the capacity of those banks and their decisions makers, and the capacity of the Reserve Bank, to respond quickly and effectually to distress. In these ways, it contributes to the goals of promoting the soundness and efficiency of New Zealand's financial system, and avoiding the significant damage that could arise if a bank were to fail.

## 2 The benefits and risks of hosting foreign-owned banks

Foreign ownership of New Zealand banks can benefit New Zealand's financial system, but can also pose additional risks over and above those that arise with New Zealand-owned banks.<sup>5</sup> Many of those risks stem from the jurisdictional boundaries that lie between New Zealand and the countries of domicile of the foreign owners and related parties of New

Zealand banks. In the case of the four largest banks in New Zealand, these risks are of particular concern because each of those banks individually comprises a significant proportion of New Zealand's banking system.<sup>6</sup>

The Reserve Bank devises policy to best promote the rewards and minimise the risks of hosting foreign-owned banks. The local-incorporation policy is part of the framework for pursuing those ends. Identifying some of the important risks and benefits of hosting foreign-owned banks is thus the first step towards explaining the rationale for the local-incorporation policy.

Often-cited benefits for banks of having connections with foreign banking operations include the following:

- economies of scale and of scope;
- benefits from access to the expertise and technology present in foreign operations of the global company;
- benefits for funding costs from being linked with a global banking group that has a strong credit rating; and
- access to funding and operational support from related parties.

To the extent possible, any policy action should try to maximise those benefits while minimising any accompanying risks.

Some of the risks associated with foreign ownership are outlined below. They are discussed in further detail in section 4, in the discussion of the risk-mitigation effects of the local-incorporation policy.

- Prudential supervisors' objectives can differ between home and host countries. At the extreme, statutory obligations might require a home-country supervisor to take actions that could harm financial stability and efficiency in the host country, or vice versa.
- Some home countries have legislation giving home-country creditors a priority claim over a bank's assets. That could be to the detriment of foreign (host-country) creditors if the home-country creditors' priority claim extended to the assets generated by foreign (host-

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<sup>3</sup> Hull (2002) looks at the wider implications of foreign ownership of banks for New Zealand's financial stability.

<sup>4</sup> The local-incorporation policy allows such foreign-owned banks to operate a branch, subject to limits on the branch's size and retail-deposit-taking capacity, in addition to their locally incorporated subsidiary.

<sup>5</sup> Bollard (2004) and Woolford and Orr (2005) discuss issues raised by hosting foreign-owned banks and outline the Reserve Bank's response.

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<sup>6</sup> In the language of the local-incorporation policy, each is "systemically important" (section 3).

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country) branch operations. Creditors of such branches would thus find it difficult to assess, ex ante, their likely position in the event of a failure.

- Jurisdictional boundaries can make it legally and practically difficult for a host-country bank or regulator to enforce undertakings made by an offshore related party, or to challenge actions taken by such a party or by a home-country regulator. This would particularly be a problem if it were necessary to seek some enforcement or other action in a foreign court under foreign law.
- The interests of a foreign legal entity that owns a New Zealand bank, or of a home-country banking supervisor, might not always be the same as those of the New Zealand bank or of the Reserve Bank. If the owner or a home-country supervisor had powers to direct a New Zealand local banking operation, there would be a risk that such directions might not be in the best interests of the New Zealand operation and financial system.
- A troubled parent bank or offshore related party could affect the reputation, operating capacity or financial position of a New Zealand bank.

As well as promoting these benefits and minimising these risks, the Reserve Bank seeks to ensure that any new banking-policy development fits in with the wider supervisory regime to the extent possible. That includes supporting the effectiveness of market discipline and self-discipline which, as noted earlier, play important roles in the Reserve Bank's supervisory regime. New policy must also account for the particular features of New Zealand's banking-supervision rules and the rules applying in the home jurisdictions of New Zealand's existing foreign-owned banks, of which the most important is Australia.<sup>7</sup>

- New Zealand has no domestic creditor preference or deposit-insurance regime.
- Australian banking law says that if a bank in Australia were to fail, its assets in Australia would be available to meet its deposit liabilities in Australia in priority to

all of the bank's other liabilities.<sup>8</sup> That preference could capture assets derived from a New Zealand branch of the bank. While New Zealand law can attempt to offset that effect, it cannot do so with certainty of effect.

- New Zealand and Australian banking regulators are required to use their powers to promote their respective public-policy interests, which are not identical between the two countries.

### 3 A policy response: the local-incorporation policy

The details of the local-incorporation policy are contained in Reserve Bank of New Zealand (2006a). That document explains that the Reserve Bank,

*. . . seeks to ensure that a registered bank is in the ownership of entities or individuals who collectively have incentives to monitor its activities closely and to influence its behaviour in a way which will improve or maintain its soundness.*

Further,

*. . . there will need to be sufficient separation between the board of a bank and its owners to ensure that the board does not have an unfettered ability to act in the interest of the owners where those interests diverge from those of the bank.*

To achieve those ends, the local-incorporation policy applies to branches of overseas-owned banks. It states that,

*All applicants which fall within the following categories, or which are expected to fall within the following categories in the 5 years following registration, will be required to establish a locally incorporated entity rather than operate via a branch:*

- *Systemically important banks, that is banks whose New Zealand liabilities net of amounts due to related parties, exceed NZ\$10 billion.*

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<sup>7</sup> The local-incorporation policy addresses issues general to cross-border banking and does not single out particular countries for attention. Nevertheless, this article refers on a number of occasions to particular trans-Tasman issues because of the significant Australian ownership of New Zealand banks.

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<sup>8</sup> The [Australian] Banking Act 1959, section 13A(3). In practice, the reference to deposit liabilities in Australia is likely to refer to depositors and deposits in Australia. Reserve Bank of New Zealand (2004a) summarises some implications of home-country depositor preference for host-country creditors of a branch.

- Retail deposit takers incorporated in a jurisdiction that has legislation which gives deposits made, or credit conferred, in that jurisdiction a preferential claim in a winding up. Australia and the United States are examples of countries with such legislation.
- Retail deposit takers which do not provide adequate disclosure in the home jurisdiction.
- Applicants other than those listed above may also be required to incorporate locally if the Reserve Bank is not satisfied that supervisory arrangements (including disclosure arrangements) and market disciplines in the country of incorporation are inadequate.

Those rules mean that New Zealand's four largest banks, all of which are Australian-owned, must be incorporated in New Zealand because of their size.<sup>9</sup> Because of Australia's home-country depositor preference regime (discussed in section 2), those same four banks are also required to incorporate in New Zealand, given that they take retail deposits of more than NZD 200 million.<sup>10</sup>

At present, no other bank in the New Zealand system meets the local-incorporation policy's definition of systemic importance or crosses the thresholds relating to retail-deposit taking. Consequently, only the large four Australian-owned banks are currently required by the local-incorporation policy to be incorporated in New Zealand. These banks are:

- ANZ National Bank Limited (owned by Australia and New Zealand Banking Group Limited);
- ASB Bank Limited (owned by Commonwealth Bank of Australia);
- Bank of New Zealand (owned by National Australia Bank Limited); and

- Westpac New Zealand Limited (owned by Westpac Banking Corporation).

## 4 Benefits and costs of the local-incorporation policy

Previous sections have described the local-incorporation policy, its practical implications for banks' operations in New Zealand, and the problems that it seeks to address. That material underlies the discussion in this section, which considers some of the merits and costs of the policy itself.

### Why a local-incorporation requirement?

The main benefits of local incorporation come through the concomitant legal personality of the New Zealand bank and the presence of a local board of directors whose duties are specifically to the New Zealand bank.

Legal personality and separate local governance promote prudence and efficiency by strengthening the clarity of accountability that the bank and its decision makers have for the bank's performance. Clarity of accountability provides strong incentives to run the bank prudently and efficiently, and provides levers by which regulatory discipline can act on the bank and its decision makers.

As discussed below, strong governance and legal personality can help provide certainty about a bank's financial position and enhance the chances that any distress could be dealt with quickly and effectively. Importantly, they can help to ensure continued provision at all times of a bank's essential functions (such as those relating to the provision and circulation of liquidity in the financial system). Banks' customers and counterparties rely on the continued provision of those functions, and so their ongoing provision is required for the financial system to be robust and efficient.

Legal personality and separate local governance allow a New Zealand bank and its staff to act in the bank's own best interests, even where to do so might not best promote the interests of the New Zealand bank's parent bank. Were a bank to operate as a branch, there would be no separate local governance or legal personality, so situations could arise in which the staff of the New Zealand operation, or directors

<sup>9</sup> Alternatively, they could divert sufficient business away from their branch operations to keep those branch operations under the local-incorporation policy's size threshold.

<sup>10</sup> Reserve Bank of New Zealand (2006a) states that: 'For the purposes of these requirements a retail deposit taker is defined as a financial institution that has more than \$200 million in New Zealand retail deposits on its books. Retail deposits are defined as deposit liabilities held by natural persons, excluding liabilities with an outstanding balance of more than \$250,000'.

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of the legal entity of which the New Zealand branch is a part, would be required to act in the best interests of the legal entity as a whole, even if those actions were not in the interests of the New Zealand operation.

Section 131 of the Companies Act 1993 requires directors of a locally-incorporated company to act in the company's best interests when exercising their powers and performing their duties. Other sections of the Companies Act require directors to act prudently and diligently. Adding further emphasis to directors' incentives to govern effectively, the Reserve Bank requires directors of locally-incorporated banks to make attestations in a bank's published disclosure statements relating to the prudence of the bank's behaviour and to the bank's compliance with its conditions of registration. The Reserve Bank also requires that directors attest to the veracity and completeness of the content of disclosure statements.<sup>11</sup>

To reinforce the duties of local directors to a New Zealand-incorporated bank, the Reserve Bank also imposes conditions on locally-incorporated banks' registration requiring:

*That the bank's constitution does not include any provision permitting a director, when exercising powers or performing duties as a director, to act other than in what he or she believes is the best interests of the company (i.e. the bank). (Reserve Bank of New Zealand, 2006a)*

That seeks to avert the risk that a bank's constitution might be written so as to allow directors to act in the best interests of a holding company, even where doing so would be contrary to the interests of the New Zealand company.<sup>12</sup>

Added together, the rules outlined above mean that the directors and decision makers of a locally-incorporated bank have strong incentives to ensure that the bank adequately identifies, prices, allocates and manages the risks that it faces.<sup>13</sup> The rules also promote the capacity of directors to

act in the event of distress to prevent, or to minimise the damage done by, the failure of the bank. Governance of this nature contributes materially to the pursuit of the Reserve Bank's section 68 objectives.

The legal personality of a locally incorporated bank provides further benefits through the existence of a clear and legally enforceable boundary between the New Zealand bank and the global group of which it is a part. This boundary applies both to the operational aspects of the bank and to the ownership of the bank's assets, liabilities and capital (ie the bank's balance sheet).

The clear boundary around a bank's balance sheet provides greater clarity and certainty about the bank's performance and financial position. This helps markets to identify, manage and price the risk of dealing with the bank, and to allocate funds appropriately. It also underpins the accountability of the bank's decision-makers and directors. Clarity about the ownership of assets also helps reduce the risk that those assets could move between the bank and its related parties at less-than-fair value, if some other part of the global group were to experience difficulties.

Certainty about a bank's balance sheet is also important for preventing and managing episodes of distress. Greater certainty about the resources and obligations of the bank is important when determining the best remedial action for a banking supervisor or insolvency official to take when trying to minimise damage to the financial system.<sup>14</sup>

Balance-sheet separation means that the Reserve Bank can set prudential capital requirements (and other quantitative prudential requirements) for locally incorporated banks. Capital acts as a buffer against unexpected losses on a bank's portfolio. By contrast, a branch cannot hold its own capital, and so must depend on the capital adequacy of the legal entity of which the branch is a part. If the legal entity of which the branch is a part were overall experiencing difficulties, home-country regulatory objectives or creditor-protection rules could cause the entity's capital to be used

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<sup>11</sup> Reserve Bank of New Zealand (2005b) provides an overview of the Reserve Bank's disclosure and attestation requirements.

<sup>12</sup> Section 131 of the Companies Act provides for such allowances in constitutions to be effective in the absence of such a restriction on the content of constitutions.

<sup>13</sup> Hunter, Orr and White (2006) suggest that ". . . the preconditions for financial stability are met when all financial system risks are adequately identified, allocated, priced and managed".

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<sup>14</sup> Clarity about the financial position of a distressed bank helps decision-makers to assess, among other things: whether the bank could be sold to another party and recapitalised; how large a "haircut" to the bank's creditors would be needed to recapitalise the bank; and whether the provision of Reserve Bank liquidity support would be effective.

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to the advantage of the home-country operation or its creditors, even where to do so would be to the detriment of the New Zealand operation.

Legal personality is necessary for a bank to manage on its own behalf any outsourcing arrangements, and so for ensuring that the bank can continue to perform essential functions through difficult periods. With systemically important banks, an inability to continue providing and circulating liquidity will affect a large number of customers and counterparties, and so pose a material threat to the robustness of the financial system.

Legal personality allows the bank to contract on its own behalf more generally, and to pursue legal enforcement of contracts, including outsourcing agreements, on its own behalf (as might be required if the bank or a provider of outsourced services were to experience distress).<sup>15</sup> This supports the continuity of a bank's functionality should the bank or a service provider experience stress. Further, the duty of a locally incorporated bank's decision makers to act in the best interests of the New Zealand company at all times provides strong incentives to ensure that effectual arrangements are in place for backup means of service provision should the primary provider fail to deliver. In short, a locally incorporated bank is likely to be better able and more likely to manage outsourcing risk effectively than a branch would be.

Outsourcing risk can be particularly important when a foreign owner provides services to a New Zealand bank. A New Zealand-incorporated bank can, and would be expected to, devise a legally enforceable and commercially robust contract with its parent bank. A branch would be in a weaker position, having to rely on the willingness of the home-country operation to continue providing the service, and being unable to take legal action against its own head

office for enforced service provision.<sup>16</sup>

### **Policy thresholds: systemic-importance and retail-deposit-taking thresholds**

The costs of incorporating and of operating as a locally-incorporated bank (including, for example, maintaining a separate board of directors) are likely to be more burdensome to smaller banks than to systemically important banks. If local incorporation were required of all foreign-owned banks, that cost might deter foreign banks from establishing small New Zealand operations to test the desirability of longer-term and ultimately larger-scale operation in New Zealand. Entry and the threat of entry are desirable in general because they promote competition and efficiency, and entry by international banking operations in particular can provide additional access to offshore expertise and technology.

The local-incorporation policy therefore does not require all foreign banks with operations in New Zealand to incorporate locally.<sup>17</sup> Large banks can better absorb any costs associated with local incorporation. Prior to the policy's introduction, a number of the large banks now affected by the policy already operated in locally incorporated form. This suggests that operating in that form is not materially more costly for those large banks than operating solely through branches of their global groups, or at least that the benefits to those banks of incorporating in New Zealand exceed the costs.<sup>18</sup> At the same time, large banks individually pose greater risks to the financial system than do small banks. There is likely, therefore, to be greater risk-reduction value at smaller cost through requiring incorporation by large banks than through requiring incorporation by small banks.

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<sup>15</sup> By contrast, a New Zealand branch of a foreign-owned bank is legally part of a foreign legal entity, and so would have to rely on that legal entity to pursue enforcement of operational agreements. The foreign legal entity might be unable or unwilling to do so if it were dealing with wider group distress.

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<sup>16</sup> If the home-country operation or wider legal entity were in distress, it might need to cease service provision to a branch for the sake of the overall health of the wider legal entity. Similarly, a home-country regulator or statutory manager might be required to direct the legal entity to cease provision. A New Zealand-incorporated bank would be more likely to have in place contingency arrangements to ensure the continued availability of essential services.

<sup>17</sup> As discussed below, the local-incorporation policy requires incorporation of only a subset of smaller banks. That subset comprises retail-deposit-taking banks from jurisdictions with home-country depositor preference or with inadequate home-country disclosure (Reserve Bank of New Zealand, 2006a).

<sup>18</sup> Further, the policy allows a large bank to retain a small branch in addition to its locally incorporated operation. This allows for any efficiency benefits from undertaking wholesale banking business through a branch.

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Distress in a systemically important bank can harm the financial system through any of a number of channels. The larger the bank, the larger the number of creditors affected by a failure and so the greater the reduction in confidence and activity in the financial system. Similarly, even if a large bank remained solvent but was unable to make and receive payments, the liquidity and confidence of many customers and counterparties would be affected (including other banks and their customers and counterparties). The ability of banks and of the banking system to perform their roles effectively depends on markets maintaining confidence in them.

In addition to the distinction made between large and small banks, some small foreign-owned retail-deposit-taking banks can pose risks (discussed below) that make it desirable that they should incorporate in New Zealand. In particular, the local-incorporation policy limits retail-deposit taking by branches of banks with home-country depositor preference or inadequate home-country disclosure.

This limit for retail-deposit takers from such countries does not reflect any direct objective to protect depositors. Rather, it is aimed at the Reserve Bank's section 68 objectives, recognising the risk that perceived "unfair" adverse outcomes for retail depositors could harm financial-system efficiency, and that any loss in confidence could also detract from soundness.

For market discipline to be effective, creditors need to be able to understand a bank's financial position and the likely position of creditors in a failure. Where a bank is a branch of an entity incorporated in a jurisdiction with home-country depositor preference, the New Zealand branch's assets could be put towards the claims of home-country depositors in priority to New Zealand (and all other) creditors if the entity should fail.<sup>19</sup> Similarly, if a foreign bank with a New Zealand branch disclosed insufficient or poor-quality information about the group's business, New Zealand creditors would find it hard to assess the risk of dealing with the New Zealand branch and might consider any losses that they might incur upon failure to be 'unfair'.

These problems, which do not arise with locally incorporated

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<sup>19</sup> Reserve Bank of New Zealand (2004a) discusses the implications of home-country depositor preference for host-country creditors of a branch.

banks, would be particularly acute for retail depositors. Retail depositors tend to have less capacity than larger (wholesale) creditors to assess risk in the face of such complications. They are thus more likely to be surprised by an adverse outcome if such a bank were to fail, and to feel that insufficient information had been available to adequately assess and account for the risk. Retail depositors also tend to be less able to work around the surprise loss of liquidity or wealth stemming from an unexpected outcome, should a bank with such characteristics fail.<sup>20</sup>

In such circumstances, distress to a relatively small bank could cause liquidity problems and a loss in confidence for a relatively large number of small depositors. These liquidity problems would hinder their day-to-day activities more than might be the case if they could have understood and planned for that risk. Small creditors' confidence in banks in general could also, in turn, make the banking system more prone to runs by depositors. Consequently, it is possible that problems at a relatively small bank of this kind could harm the wider financial system.

### How the local-incorporation policy supports other prudential policies

As noted above, in recent years, the Reserve Bank has initiated a collection of work-streams to promote the effectiveness of banking supervision and failure management in a world of international banking.<sup>21</sup> In many instances, these complement, and are complemented by, the work being driven by the Trans-Tasman Council on Banking Supervision.<sup>22</sup> The Reserve Bank's work has included:

- addressing preparedness for trans-Tasman crisis management;<sup>23</sup>

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<sup>20</sup> Policy problems caused by allowing wholesale deposits in a branch are expected to be of a smaller order of magnitude than would be expected with retail depositors. Wholesale customers are likely to be in a better position to assess the adequacy of disclosure and risks involved in dealing with a bank, and to maintain arrangements to address those risks (such as multiple banking relationships) (Reserve Bank of New Zealand, 2006a).

<sup>21</sup> Bollard (2004 and 2005) discusses some of these work-streams.

<sup>22</sup> On the work of the Trans-Tasman Council on Banking Supervision, see, for example, DeSourdy (2006).

<sup>23</sup> Reserve Bank of New Zealand (2006e) summarises some of these developments.

- progress on frameworks for more-general regulatory cooperation between the Reserve Bank of New Zealand and the Australian Prudential Regulation Authority;<sup>24</sup>
- rules aimed at addressing the risk caused by banks' outsourcing; and
- policies promoting effective governance of New Zealand banking operations.<sup>25</sup>

The outsourcing policy and banks' governance both benefit from the effects of the local-incorporation policy, as does the Reserve Bank's capital-adequacy policy.

The Reserve Bank's outsourcing policy builds on the presence of a New Zealand board of directors and the existence of legal personality that are provided by the local-incorporation policy. As discussed above, legal personality and strong local governance help to manage the legal and practical risks associated with outsourcing.

Legal separation enables New Zealand-incorporated banks to hold capital on their own balance sheets above certain minimum levels, as required of locally incorporated banks under the Reserve Bank's capital-adequacy regime.<sup>26</sup> As well as providing the basis for medium-term growth of a bank, that capital acts as a buffer allowing the bank to remain solvent in the event of unexpected losses.

The separate legal personality, balance sheet and capital of locally incorporated banks help to protect them from the effects of distress in offshore related parties or parent banks. Because a branch's balance sheet is inextricably part of the balance sheet of a larger legal entity, the branch's success or failure is much more closely tied to the fortunes of the global bank. The local-incorporation policy thus helps to narrow this channel through which New Zealand's financial system can be harmed by macroeconomic and financial shocks

elsewhere in the world. In light of New Zealand's extensive links to the global economy through other channels, an extra buffer of this nature helps to mitigate the harm that might be done to our financial system (and so economy) in the face of offshore stresses.

## 5 Conclusions

The local-incorporation policy reflects the Reserve Bank's goal of maximising the benefits and minimising the risks of hosting foreign-owned banks. It does that by providing banks with strong local governance, legal personality and a legally distinct balance sheet.

Those characteristics promote prudent and efficient management of banks in normal times. The same characteristics help put banks, their decision makers and their supervisors in positions to react as quickly and effectively as possible to emerging stress. They can help to limit the extent to which problems experienced by a global bank will affect its New Zealand operation and so the New Zealand banking system. At the same time, the local-incorporation policy's requirements promote the existence of the conditions in which banks and their customers have the information and incentives to identify, price, allocate and manage the risks that they face.<sup>27</sup>

The local-incorporation policy provides a platform on which other policies can be built to promote good outcomes for New Zealand's financial system. Good governance is beneficial for the financial system in a range of ways. The Reserve Bank's outsourcing policy requires large banks to manage the risk stemming from outsourcing the performance of certain essential functions. In doing that, it takes advantage of the local governance and legal personality of large banks to ensure that they manage the risk of outsourcing without the Reserve Bank needing to impose prescriptive rules about how banks may arrange their businesses. When designing New Zealand regulation, and supervising banks, the Reserve Bank aims to ensure that our requirements are compatible with the rules of home-country regulators. The recent work

<sup>24</sup> Reserve Bank of New Zealand and Australian Prudential Regulation Authority (2003) and (2005) discuss arrangements for information sharing and for cooperation in implementing the Basel II capital-adequacy framework.

<sup>25</sup> See Reserve Bank of New Zealand (2006c) and (2006b). Bollard (2004) discusses the Reserve Bank's interest in promoting strong governance.

<sup>26</sup> Reserve Bank of New Zealand (2005a) summarises the Reserve Bank's existing capital adequacy framework. Yeh, Twaddle and Frith (2005) discusses the rationale for capital requirements and introduces the new 'Basel II' Capital Framework and the Reserve Bank's approach to implementing it.

<sup>27</sup> Hunter, Orr and White (2006) suggest that some general preconditions for financial stability are met when all financial system risks are being adequately identified, allocated, priced and managed.

## Box 1

### Policy development and implementation

Given the importance of the local-incorporation policy to the Reserve Bank's supervision of banks and the potential implications of the policy for affected banks, the development and implementation of the policy have stretched over several years and have been punctuated by an extensive consultation with banks. The policy was implemented in the second half of 2003 by introducing new conditions of registration for banks operating as branches of foreign-incorporated companies.

When the local-incorporation policy was introduced, Westpac Banking Corporation, an entity incorporated in Australia, was operating through a branch in New Zealand that exceeded both the local-incorporation policy's systemic-importance threshold and the policy's limit on retail-deposit taking by banks from a country with home-country depositor preference. Initially, Westpac Banking Corporation was not required to operate under the local-

on trans-Tasman regulatory cooperation contributes in this area to reducing some of the risks posed by hosting foreign-owned banks.<sup>28</sup> Nevertheless, jurisdictional boundaries and political boundaries remain, and in that context banking supervisors are very likely to continue to have domestically-focused objectives for which they must use their oversight and crisis-management powers. In such circumstances, the Reserve Bank's local-incorporation policy will remain valuable as a tool to help in promoting the maintenance of a sound and efficient financial system, and avoiding the significant damage to the financial system that could stem from a bank failure.

incorporation policy while it discussed with the Reserve Bank whether an alternative to local incorporation could satisfy the objectives of the local-incorporation policy.

Westpac proposed 'bolstering' its branch operation in ways that sought to mitigate the risks addressed by the local-incorporation policy. In late 2004, the Reserve Bank concluded that Westpac's proposal would not constitute an acceptable alternative to compliance with the policy, and therefore required that Westpac should operate in line with the local-incorporation policy.<sup>29</sup>

On 31 October 2006, Westpac New Zealand Limited was registered as a New Zealand-incorporated bank. Westpac New Zealand Limited is a New Zealand-incorporated subsidiary of Westpac Banking Corporation. On 1 November 2006, assets and liabilities were transferred from the books of Westpac Banking Corporation and vested in Westpac New Zealand Limited.<sup>30</sup>

All systemically important banks operating in New Zealand are now locally incorporated, in compliance with the local-incorporation policy.

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<sup>28</sup> See, for example, DeSourdy (2006) and Reserve Bank of New Zealand and Australian Prudential Regulation Authority (2003) and (2005). There has also been communication between the Reserve Bank and the Australian Prudential Regulation Authority about how the two countries might respond to a banking crisis.

<sup>29</sup> Reserve Bank of New Zealand (2004b), Westpac Banking Corporation (2004).

<sup>30</sup> Reserve Bank of New Zealand (2006d). Westpac Banking Corporation retains a branch in New Zealand, but that branch is limited in size and the nature of its business under the dual-registration rules of the local-incorporation policy.

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