The Reserve Bank's policy on outsourcing by banks

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This article explains the Reserve Bank of New Zealand's policy on outsourcing by banks. Banks in New Zealand typically outsource a range of business activities, both to independent and to related-party service providers, and both domestically and offshore. The predominance in our banking system of banks owned by offshore parent banks, who provide important services to their subsidiaries, means that cross-border, related-party outsourcing is of particular relevance. The outsourcing policy requires a large bank's board to maintain legal and practical control over any outsourced functions such that the bank is able to continue to play its key role of supporting financial activity in the economy, both under normal circumstances and (particularly) under stress. The Reserve Bank applies the policy with some flexibility to suit the circumstances of individual banks. The policy thus ensures that the banking system retains the ability to avert distress, and underpins the Reserve Bank's ability to manage a financial crisis, while enabling the financial system to enjoy the benefits of foreign bank participation.

1 Introduction

In today's world of global banking and a highly specialised business environment, it is common practice for banks to enter into domestic and cross-border outsourcing arrangements for an increasing range of business activities. The outsourcing providers involved can take a range of forms, including independent specialist providers (such as IT companies) serving a range of industries, and wholly-owned special-purpose subsidiaries within a banking group that provide services to banking subsidiaries elsewhere in the group. Functions outsourced may include the following (either certain aspects or the whole function):

- development of banking application software, and running of banking software on the provider's computers;
- other IT 'infrastructure' functions such as the maintenance of facilities to house customer data and other bank records;
- 'back-office' functions such as processing and settlement of payment instructions;
- finance and accounting; and
- call centres and other customer services.[2]

In New Zealand, outsourcing by banks has reached further across the range of banking activities than is typically the case in most countries, and there remain some strong commercial incentives for banks to continue to seek outsourcing opportunities both domestically and offshore. This probably reflects the predominance in New Zealand's banking system of banks that are either owned by, or are branches of, offshore parent banks – which is itself a reflection of the openness of the New Zealand banking system to foreign bank participation.

This openness provides benefits to the banking system, but comes with risks.[3] The benefits for the local operations may include cost reduction, access to offshore expertise, and attractive funding terms associated with the global bank's (much) larger balance sheet. The risks include 'contagion' through the very same links to foreign operations, which may act as channels for operational or financial distress at the parent bank to spread to the New Zealand operations.

Risks also stem from the parent bank's offshore domicile itself, on the other side of the jurisdictional boundary from the local operation.[4] The jurisdictional boundary creates risk from foreign financial supervisors' legal obligations being, in general, different to the Reserve Bank's. In some cases, there is foreign legislation explicitly conferring a preference on local depositors. The foreign domicile of the parent bank

1 Thanks to Willy Chetwin, James Twaddle, Steve Anderson, Adrian Orr, Bernard Hodgetts and Peter Brady for helpful comments on earlier drafts of this article.

2 Joint Forum (2004) provides a useful survey, and discusses the supervisory issues raised.

3 Bollard (2004) and Woolford and Orr (2005) discuss the issues raised by hosting foreign-owned banks.

4 Kane (2006) and Kaufman (2004) provide surveys of some of the relevant jurisdictional and political issues.

also means that it is legally and practically more difficult for the local bank, the Reserve Bank or the New Zealand courts to enforce a contract with the parent bank, compared to a contract with a local provider – in part because of the possibility of frustration of the contract or some other intervention by the provider's regulator.

In the case of the four largest banks in New Zealand,[5] these risks are of particular concern because each bank by itself accounts for a large proportion of the banking system. Moreover, the New Zealand economy is highly dependent on foreign funding, and the bulk of this foreign funding is intermediated through the large banks.[6] Finally, the New Zealand operations of global banks are all small relative to those banks' overall operations, so the interests of a parent bank or banking group as a whole may not always be consistent with the interests of the local operations. Local bank staff may thus not always have the ability or incentive to act in ways consistent with the interests of the local operations.

Against that background, a number of the Reserve Bank's policies and activities are directed towards maximising the benefits of an open banking system, while minimising the concomitant risks. The next section sets out this legal and policy context, and the third section explains the outsourcing policy itself.

2 Legal and policy context

Chetwin (2006) provides a recent discussion of the Reserve Bank's supervisory approach in the context of the Reserve Bank's local-incorporation policy. The same principles frame the rest of the banking supervision regime, including the outsourcing policy. In brief, the regime gives effect to the requirement in section 68 of the Reserve Bank of New Zealand Act 1989 (the Act) that the Reserve Bank must supervise banks 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.

The regime comprises three elements:

- legal responsibilities for a bank's decision makers to operate the bank prudently and efficiently;
- required disclosures by banks to enable creditors and financial markets to monitor bank performance; and
- rules and minimum standards relating to a bank's business.

The regime emphasises the first two – more market-based – approaches, supplemented by the minimum standards where necessary.[7] In the event of financial distress, the Reserve Bank has a range of crisis-management powers and tools to prevent wider damage to the financial system. These range from issuing directions to troubled banks, through to statutory management. Statutory management may result in liquidation, or partial or full recapitalisation by new investors.

The outsourcing policy is a major plank in the policy platform supporting the Reserve Bank's ability to manage financial distress. Two other key elements of this platform are the local-incorporation policy,[8] and day-to-day cooperation between a global bank's headquarter ('home') supervisor and the Reserve Bank (as 'host' supervisor of the global bank's New Zealand operations).

The local-incorporation policy provides legal personality and strong local governance for the New Zealand operations of foreign-owned banks. Among other things, these elements strengthen the ability of the New Zealand operations to manage the legal and practical risks associated with outsourcing.

Cooperation between home and host supervisors helps build the relationships that facilitate quick and concerted action in times of stress. In the case of the Australian-owned banks in New Zealand, this cooperation has been bolstered by recent legislation in New Zealand and Australia that imposes formal obligations on the respective supervisors – where reasonably

5 ANZ National Bank Limited, ASB Bank Limited, Bank of New Zealand Limited and Westpac New Zealand Limited.
6 Hull (2002) discusses in detail.
7 See Bollard (2004) and Bollard (2005).
8 Chetwin (2006) discusses the local incorporation policy in detail.

practicable – to consult each other and to avoid actions that may have a detrimental effect on financial stability in the other country.[9]

3 The Reserve Bank's outsourcing policy for large banks[10]

In order to manage a financial crisis effectively and to limit the risk of a taxpayer-funded rescue of a distressed bank, it is vital that there exists the legal and practical ability to continue to operate a failed bank under statutory management. A large bank that outsources its business activities must also be able to continue to function in the event that its service provider fails or becomes dysfunctional, or in the case where the provider is a parent bank, becomes subject to the administration of a foreign supervisor. For both of these purposes, it is essential that the bank in New Zealand has access to the customer records, people and systems it needs to continue operating.

The outsourcing policy was developed to address these scenarios. As discussed in Joint Forum (2004), many financial supervisors around the world have put outsourcing policies in place to ensure that the financial institutions in their jurisdiction do not compromise their abilities to meet their obligations to customers. In New Zealand's case, consistent with the Reserve Bank's statutory obligations, the focus is on the stability of the financial system, rather than bank customers *per se*, although a focus on the financial system clearly has benefits for customers also. The Reserve Bank's outsourcing policy, like those of other supervisors generally, does not seek to ban outsourcing outright, but addresses the risks that outsourcing of certain functions may present to supervisory objectives.

The policy is aimed at large banks, whose size makes them important to the financial system. It is not limited to the cases of cross-border outsourcing or of related-party outsourcing. However, these cases are particularly significant in New Zealand's banking system, because of the predominance of subsidiaries that are wholly owned by offshore parent banks.

The policy requires large banks to structure their business so that each bank's board of directors has legal and practical ability to control and execute all functions needed for the bank to continue to provide and circulate liquidity to the financial system. These 'core functions' include providing payments and transactions capability to the bank's customers. This ability must exist both under normal business conditions and under circumstances of stress or of failure of the bank or of a service provider to the bank.

The policy also requires that a large bank's board of directors must act in the interests of the New Zealand bank, including where the bank is a subsidiary of an offshore parent bank, and that the staff of the bank are accountable to the board of the New Zealand bank. The use of parent-bank systems, tools and techniques by a New Zealand subsidiary is of course permitted, but only under the full oversight and acceptance of the subsidiary's board. This oversight applies to all aspects of the subsidiary's operations. The relevance of this provision again relates to the need for sufficient legal and practical ability to control the bank's affairs such that it can continue to provide its core functions, as set out in the policy, without material interruption in the event of stress.

The focus on liquidity circulation reflects the urgency of this function under crisis management conditions. Crisis management can be thought of as having two phases (see figure 1).

The *first phase* is the very short period, perhaps a day or two, immediately following the emergence of distress at a bank. In this phase, the Reserve Bank and the bank's statutory manager must make decisions about whether and how to restore liquidity or solvency to the bank, and about how to maintain its core functions and meet its settlement obligations if it is a large bank. The continuity of a large bank's core functions is necessary to avoid a potentially disastrous contraction in financial system liquidity. Such a contraction in liquidity could occur if interruption to the core functions caused the bank to fail to settle, or caused the bank's payment, settlement and intermediation capacity to shut down suddenly.

9 **DeSourdy (2006) discusses this legislative initiative.**

10 **Reserve Bank of New Zealand (2006b) sets out the outsourcing policy itself, and Reserve Bank of New Zealand (2006b) provides a set of questions and answers about the policy.**

Figure 1
Phases of bank crisis management

	First (initial few days)	Second (subsequent weeks, months or years)
Phase:	• distress apparent • urgent action needed • objective: stabilise financial system and preserve options	• bank and financial system stabilised • objective: choose best option for exit from statutory management
	TIME →	
Decisions:	• lender of last resort support? • meet distressed bank's settlement obligations? • restore solvency (how)?	• liquidate, sell, continue to run?

In the first phase, a statutory manager needs immediate access to the bank's systems, customer records and staff associated with its core functions, and these systems need to be intact and operational. The systems include those needed to clear and settle the bank's and its customers' local and foreign currency settlement obligations on the day they fall due, and all interfaces with the domestic and international payments and settlements infrastructure. The emphasis and urgency related to continuing the bank's payments and liquidity provision functions is due in part to the interconnectedness of banks and other financial institutions via the payment system. This interconnectedness creates channels through which one bank's liquidity problems can spread to other banks and the wider economy, if not contained and managed promptly.

The *second phase* is the potentially lengthy subsequent period, during which the Reserve Bank and the statutory manager must decide what to do with the failed bank over the longer term. It involves decisions around 'exit' from statutory management – in other words, whether recapitalisation, sale in whole or part, or liquidation may be pursued. As noted earlier, it is important upon initiating statutory management to have options in the first phase that avoid destroying economic value, unnecessarily risking taxpayers' money, or constraining the exit options in phase two. The outsourcing policy is partly aimed at ensuring that there is sufficient legal and practical control over core functions, so that all reasonable options are preserved.

The policy is not prescriptive about the means by which a bank should achieve the necessary legal and practical ability to control and execute its core functions. Rather, its requirements are set in terms of outcomes the bank must achieve – that is, legal and practical ability to control, and continued provision of core functions. This outcomes-focused approach was chosen to avoid risks of unintended consequences, and to preserve banks' incentives to innovate, as much as possible. The approach reflects that financial system efficiency is one of the Reserve Bank's purposes as set out in section 68 of the Act. Consistent with this approach, banks have flexibility to meet the policy's requirements in a way that best suits their individual circumstances and business models, subject to demonstrating that their particular proposed arrangements achieve the appropriate level of legal and practical ability to control.

The policy discusses a range of risks that are relevant to banks' ability to meet the required outcomes. The risks include those associated with the jurisdictional boundary between the New Zealand bank and any offshore service provider, including a parent bank, as outlined above. Where services are sourced from remote locations, the risks may also be operational in nature, for example where multiple time zones are crossed, statutory holidays are different, or extra time is needed to access essential staff and systems.

Risks in outsourcing arrangements when the provider is a parent bank in an offshore jurisdiction may be reduced by supervisory cooperation, and foreign legislation providing some assurance that service arrangements will, where reasonably practicable, be maintained. These factors become particularly relevant during the second phase of crisis management involving a global bank, when significant co-operation and coordination could be expected to occur between the relevant home and host regulators and statutory managers.

4 Conclusion

Political, jurisdictional, and currency-related boundaries remain in the world, meaning that banking supervisors – both the Reserve Bank of New Zealand and its foreign counterparts – are likely to continue to have domestically-focused objectives for some time. In this environment, foreign bank participation in local banking systems involves risks as well as benefits. Regular supervisory cooperation and, where politically tenable, legislation requiring a regard for other countries' interests can mitigate the risks to some extent. To strike the right balance between the risks that remain, without unduly reducing the benefits of an open banking system, the Reserve Bank maintains a range of requirements under its outsourcing policy. This policy ensures that large banks operate with adequate legal and practical control over their core functions, which underpins the banks' ability to avert distress, and enables the Reserve Bank effectively to manage a crisis and to preserve options through the resolution of a large bank failure.

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