



Supplementary submission to the

Reserve Bank of New Zealand

**Consultation on revised BS 11
Outsourcing Policy**

25 November 2016

Strictly Confidential

1.0 INTRODUCTION

- 1.1 This supplemental submission has been prepared by Bank of New Zealand (BNZ) in response to the Reserve Bank of New Zealand's consultation document, Consultation paper: Revised policy proposals for the review of the outsourcing policy for registered banks released on 23 May 2016.
- 1.2 BNZ appreciates RBNZ allowing it to make this supplemental submission on the consultation document.
- 1.3 This submission contains commercially sensitive information and is provided on the basis that this information is kept strictly confidential. The sensitive information may only be released by RBNZ with BNZ's prior permission.

2.0 EXECUTIVE SUMMARY

- 2.1 This submission follows on from discussions between RBNZ and the BNZ during the prudential consultation meeting held in Auckland on 11 November 2016.
- 2.2 The prudential consultation discussion was very helpful in improving BNZ's understanding of the type of tail risk event RBNZ is seeking to address through its proposed revision of BS11.
- 2.3 As previously submitted, BNZ supports the financial stability outcomes RBNZ is seeking to achieve through this reform. In addressing the risk, BNZ submits that an effective trans-Tasman crisis management framework remains the most important first step and acknowledges the work undertaken by RBNZ and its consideration of the recent suggested changes to the relevant legislation and memorandum of cooperation. In parallel with this, and based on the risks articulated in the prudential consultation, BNZ has completed further work to investigate the ways RBNZ's intended outcomes might be achieved through the use of alternative supplier arrangements where services are shared by a parent and subsidiary bank.
- 2.4 The purpose of BNZ's further work is to provide RBNZ with additional information to help ensure that the revised policy is framed in such a way that banks and their customers are able to access the service and cost benefits of services provided by/with parent banks, while also ensuring RBNZ's objectives are achieved. This should help to ensure the costs are more proportionate to the risk and that the resulting changes do not divert scarce technology resources away from delivering increased resilience and innovation.
- 2.5 BNZ supports the retention of the outcomes based focus of the outsourcing policy as this helps ensure banks have a degree of flexibility in the way that they might comply with the policy. As long as a bank can demonstrate it has legal and practical control over its outsourced functions, the policy should not foreclose on the use of any viable option.

- 2.6 BNZ submits that the revised policy should have sufficient scope to allow a New Zealand bank with an offshore parent, to outsource to a shared multi-tenanted service provider. The provider of the multi-tenanted service could be either:
- (i) an independent third party which is not a related party of either the parent or the subsidiary; or
 - (ii) a Special Purpose Vehicle (SPV) configured in such a way so that it is controlled by neither the New Zealand subsidiary nor its parent - for example, via a 'service company' that is owned and controlled 50/50 by the New Zealand bank and its parent.
- 2.7 For the avoidance of doubt about the way industry might interpret and apply an outcomes based policy, its wording should expressly provide for critical services from a shared multi-tenant service provider as described in paragraph 2.6 above. The policy should also make it clear, again for the avoidance of doubt, that provided appropriate arrangement are in place, there is no requirement for a New Zealand subsidiary to have a robust standby capability to which it can switch to abruptly as part of its separation plan.
- 2.8 BNZ would welcome the opportunity to work with RBNZ, either bi-laterally or via a collective industry initiative, to develop the proposal below either ahead of the final policy being released or in the development of the exposure draft of the changes to the banking standard and/or banks' conditions of registration.

3.0 SHARED SERVICES

- 3.1 BNZ and NAB have undertaken an extensive review of the way services are shared and/or provided as part of the consultation and submission process. The conclusion reached as a result of this review is that RBNZ's intended outcome of the 'robust standby capability' requirement referenced in earlier policy consultation, namely that New Zealand subsidiary banks are able to operate independently from their parent or related parties, might be achieved with models other than the sort currently employed in the [REDACTED]
- 3.2 These models will have their own inherent legal, structural and regulatory challenges, but they do offer potential future proofing and cost benefits, noting the rapid pace of technology change and emerging third party partnering opportunities. There are no guarantees that the short term outcomes will be materially more cost effective in terms of the initial investment required (including new licencing fees, new software, new platforms etc) than alternative 'lift and shift' options that were explored in the earlier stages of the policy consultation. BNZ and NAB are still working through the associated costs estimates.
- 3.3 The significant work undertaken by BNZ and NAB has shown that relying on [REDACTED] solution (that would entail a subsidiary bank standing up a standby capability), is likely to add significant cost without providing a corresponding increase in system resilience, service offerings or innovation during times of non-crisis. The diversion of critical resources over a prolonged period to implement the required changes would

almost certainly be at the expense of investment in systems upgrades, improved resilience as we move to 'always on' platforms, information security uplift and customer innovation.

- 3.4 In the absence of more explicit provision in the policy for a shared services type arrangement, New Zealand banks are likely to face disproportionately large costs [REDACTED] as previously submitted, in BNZ's case this would be of an order of magnitude of [REDACTED] to establish compliance and an increase of [REDACTED] in annual operating costs.
- 3.5 BNZ's existing outsourcing arrangements with NAB involve a range of banking services (some core and some non-core) that have previously been advised to RBNZ – through the 2013 stocktake as well as in the course of regular supervisory activity. These arrangements typically allow BNZ to take advantage of NAB Group synergies, enjoy efficiencies of scale, and access to specialist services like Cyber Security Operations Centre, that are likely to be otherwise beyond BNZ's reach.
- 3.6 As RBNZ is aware, where these are technology services, they are governed by a Master Services Agreement. NAB will have in turn outsourced the supply of many of these technology services to [REDACTED] - in effect, this puts [REDACTED] in the position of principal contractor to NAB and a subcontractor to BNZ.

[REDACTED] Most of the infrastructure used to supply the services is owned by [REDACTED] and is housed in the [REDACTED] data centre owned by NAB for production, and [REDACTED] data centre at [REDACTED] which is leased by NAB from [REDACTED] for disaster recovery. The value in being able to leverage parent capability is reflected in the fact that both of these data centres are classified as 'Tier 3' providing system resilience [REDACTED]. The software used is a mix of NAB proprietary software and software licensed by a number of different third party software vendors. Application support is provided by a range of different parties, including [REDACTED].

- 3.8 BNZ and NAB have investigated a number of options that might enable a more efficient way of delivering on RBNZ's intended outcomes, based on the principle of legal and practical control over outsourced operations. BNZ would appreciate RBNZ's consideration of these options and efforts to ensure that none of these options would be ruled out by the Policy. These options include:
- Outsourcing to an independent third party, which also provides technology services to a parent bank - this could be from within, or external to, existing production and disaster recovery locations;
 - Establishing direct contractual relationships between BNZ and third party providers, where relevant;
 - Reconfiguring the existing legal and commercial arrangements so that a subsidiary and parent can receive the services from an SPV that is within the banking group, but not controlled by either the subsidiary or parent;
 - Internal separation within shared production and disaster recovery environments. This would involve separate infrastructure and software licences being dedicated to providing services to the subsidiary [REDACTED].

[REDACTED]
[REDACTED] and contracted with third parties for the supply of power, security, communications etc); and

- Establishing direct contractual relationships with third party service provider in another data centre provided by either that party, or an additional third party.
- Removing services from the shared outsourcing environment according to the lifecycle of the service (but within the five-year implementation period under the revised policy) and replacing them with services provided in-house or by a third party.

3.9 BNZ submits that it is unlikely that any single option outlined above would provide a comprehensive solution for all subsidiary/parent bank outsourcing arrangements. Therefore, a combination of options is likely to be required. BNZ submits that the RBNZ should ensure that the final policy wording enables a solution to be applied for individual services, rather than requiring a single unified approach across all systems. Some systems will be better suited to one option over another from a strategic alignment, cost and business benefit perspective, so it is important that this flexibility is preserved to ensure that a 'best-fit' solution can be implemented for each service.

3.10 Banks are constantly looking at ways to improve their use of technology. In a banking Group environment there is a need to ensure that parent and subsidiary technology roadmaps are well aligned where possible to give the greatest opportunity to realise the associated scale benefits.

3.11 In that context, BNZ and NAB are exploring possible legal and commercial configurations for converting their existing arrangements into a configuration, whereby both BNZ and NAB would continue to have a presence in the [REDACTED] data centres, but each receives those services under separate contracts with a series of third party vendors, or an SPV, or a combination thereof.

3.12 Legal and practical control would be established through a series of robust enforceable arms' length contracts. These would:

- give BNZ (and its contractors), third party provider or SPV an enforceable right to be present at the data centres;
- give BNZ, the third party provider or SPV enforceable rights in respect of the supply of services at the data centres, such as power, environmental (e.g. air conditioning and fire suppression) and security;
- contain the contractual provisions required by the Policy, to the extent relevant in the case of the recommended provisions;
- give BNZ direct licences to use relevant software, including any NAB proprietary software; and
- provide application support, including in respect of NAB proprietary software to be provided by appropriate third parties or the SPV.

- 3.13 Some of the options described above would potentially involve outsourcing by NAB, which may require that NAB obtain a non-objection to the arrangement from APRA. This is an example of the complexities that might arise in a shared services model and these matters would need to be worked through carefully, potentially requiring regulatory cooperation between RBNZ and APRA to deliver an acceptable solution.
- 3.14 In support of its review of potential outsourcing arrangements that might ensure legal and practical control is preserved in a crisis situation, BNZ has satisfied itself that effect can be given to the RBNZ's intended outcomes through third party contractual arrangements, provided that the right structures are put in place.
- 3.15 In summary, the principles that should be captured by the revised policy include:
- New Zealand subsidiary banks should not be restricted in the options that can be used to achieve compliance, provided that the option satisfies the 'legal and practical control' test – the 'outcomes based' focus of the policy should be retained to preserve flexibility and enable innovative responses;
 - New Zealand subsidiary banks should be permitted to use a combination of compliant options to achieve compliance;
 - A New Zealand subsidiary sharing a service with its parent in a multi-tenanted environment, using shared infrastructure and software should be permitted, provided that:
 - the service provider is not under the control of the parent; and
 - the services are provided under a robust enforceable contract between the New Zealand bank and the service provider, which provides that, among other things, the service provider shall not prefer the parent ahead of the New Zealand subsidiary bank;
 - The service provider may be an SPV that is equally owned and controlled by the New Zealand subsidiary bank and parent, or under some other configuration that is not controlled by the parent;
 - Where the service provider is a SPV within a banking group, the SPV should not be solely dependent on the parent for funding; and
 - Provided the above are satisfied it would not be necessary for a Large Bank to have a robust standby capability.

4.0 CONCLUSION

- 4.1 BNZ appreciates the opportunity to provide this supplementary submission to RBNZ on its outsourcing policy. Given the importance of the policy and the significant impacts it will have on the shape of bank technology arrangements, it is critical that the RBNZ continues to progress this reform in close consultation with the industry.
- 4.2 BNZ is available to discuss any matters raised in this submission, either prior to, or after the release of any policy, and looks forward to working with RBNZ on the exposure draft of the banking standard and conditions of registration. Noting the complexity of this matter, BNZ urges RBNZ to proceed on the basis that long term clarity and the facilitation of innovative solutions are the priority outcome, rather than adherence to any pre-determined timeframes.

4.3 Should RBNZ have any questions in relation to this submission, please contact:

[Redacted contact information]

[Redacted contact information]