FIRST UNION

Putting Workers First

# Review of the Outsourcing Policy for Registered Banks

Submission of FIRST Union

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## 1. Introduction

1.1. FIRST Union welcomes the opportunity to make a submission on the review of outsourcing policy for registered banks.

1.2. FIRST Union is a private sector union of 27,000 members working across a wide variety of industries including Finance, Industrial (Textile, Wood and Food), Retail Stores and Transport. We are the primary union in the Finance Sector and have members in all the major banking groups (except Kiwibank) and collective agreements with the most significant banks in New Zealand.

1.3. FIRST Union call for the Reserve Bank to set clear policy and expectations for banks on outsourcing arrangements. We would be concerned if the policy was watered down from the policy most likely to maintain a sound financial system, particularly given the Reserve Bank has noted that interpretation and application of the existing outsourcing policy by banks has been variable. We take this to mean that it is debatable whether banks are complying with the existing policy, but we see this as a reason to clarify expectations rather than water the policy down.

## 2. Problem definition

2.1. FIRST Union believe greater regulation of outsourcing arrangements is required in order to put the legislative requirements of Section 68 into effect. We believe there are significant risks of market failure in regards to outsourcing arrangements. For example the strong demands from shareholders for banks to declare increasing profits each year may come at the cost of the long term sustainability of the organisation.

2.2. An example of how the incentives on individual institutions may not align with the pubic good was provided by the former Reserve Bank governor Alan Bollard in his book 'Crisis' when he commented on the behaviour of the banks in response to the Global Financial Crisis in early 2008.

> *"Regardless of the benefits Australian banks in New Zealand have received in the past and the committed assistance in the form of guarantees and liquidity put in place by the New Zealand Government, their recent actions [of the banks] seemed to be driven by short-term rather than wider social concerns" (Bollard & Gaitanos, 2010, p. 148)*

2.3. According to Bollard the Prime Minister and the Minister of Finance also expressed concern that the Australian banks were not being sensitive enough to New Zealand's commercial needs. One way this could be interpreted is that by not passing on Official Cash Rate cuts by way of lower interest rates the banks also increased the cost of borrowing for businesses, and therefore increased the chances workers jobs could be at risk.

2.4. FIRST Union also fears that greater outsourcing may lead to job losses in New Zealand. If staff and decision makers are largely based overseas they will not have as much knowledge of local economic conditions and this could lead to misjudgements being made, particularly in the case of the bank or a business being in difficulty. For example seeing a number of shops close in their local street or hearing of a small number of redundancies across many industries can be a significant indicator of difficult economic times. Such indicators can often tell you relevant economic facts before they appear in the newspaper or in commentary.

## 3. Outsourcing and Bank Failure

3.1. We note that the Reserve Bank is particularly interested in how outsourcing could complicate the situation during the failure of a bank. FIRST Union believe regulatory bodies do and ought to have a responsibility to prepare as much as possible for eventualities like the failure of a bank – if the health authorities dismissed the possibility of a bird flu outbreak and did nothing they would be justly criticised (Hendren, 2006).

3.2. Unfortunately the banks themselves have generally been rather dismissive when considering the possibility of a bank failure. In 2004 Westpac dismissed the possibility of a bank failure as “a one in 900 year” likelihood. While the Australian and New Zealand banks were more stable than others through the Global Financial Crisis (GFC) this was largely because they had less scope to be involved the toxic trades at the centre of the GFC due to their position as net borrowers. Geoff Bertram and David Tripe (2012) highlight that New Zealand has seen the collapse of the Development Finance Corporation in the 1980s, the near failure of the BNZ in 1988 and 1990, as well as the failure of finance companies such as South Canterbury Finance in 2010.

3.3. In ensuring that the basic business of the bank can be maintained though the process of statutory management and/or transfer to a new owner the effect on the employees working for the bank or a contractor should be considered. This is relevant to the proposed requirement to provide basic services to existing customers (Paragraph 49). In particular, where employees are transferred to a new employer, unless a collective or individual agreement has provision for transfer of undertakings, existing employment agreements would have to be renegotiated with the new employer. Financial institutions may risk losing valuable institutional knowledge in such situations. FIRST Union has experience in advocating for members caught in receivership/liquidation situations as well as experience in the finance sector so we would welcome discussion with the Reserve Bank on these issues. We feel that our interest in maintaining the job security and working conditions of our members would have commonalities with the interest in the Reserve Bank in maintaining a sound financial system.

3.4. In the event a bank wishes to outsource or any other type of restructure, the provisions of collective agreements between FIRST Union and the banks require the banks to consult with the union and affected employees, and provide sufficient information in order for meaningful feedback to be given on the restructuring proposal and have a genuine opportunity to influence the decision. We see the proposal of the Reserve Bank to oversee outsourcing proposals as a logical extension of the kinds of consultation the banks are already obliged to undertake. It also may be helpful to the Reserve Bank to make contact with the union when assessing such proposals. For this reason we submit that the Reserve Bank retain the right to consult with relevant parties such as the Council of Trade Unions and relevant finance sector unions.

3.5. FIRST Union supports the proposal to require banks to have a robust separation plan that would describe what a bank would have to undertake in the event a parent fails or the New Zealand bank is separated from its parent. Such a separation plan would provide a good basis on which to judge outsourcing proposals, particularly given there has been pressure from the banks to allow them to centralise more operations in Australia. For example in 2004 Westpac proposed to move its mainframe computers to Australia. While this proposal was rejected by the Reserve Bank, had this proposal gone ahead this would have made it very difficult to extract the New Zealand subsidiary had Westpac faced trouble in Australia.

3.6. Geoff Bertram and David Tripe (2012) highlight ways in which banks are owned offshore and overseas parents (along with bank bondholders) might seek to ‘loot’ the New Zealand subsidiaries in a global crisis. They believe the intentions of the Open Bank Resolution policy only deal with certain aspects of the problem. Since the 1980s there has been much greater use of offshore wholesale funding to supplement deposits as a source of funding for bank lending. Such funding may be promptly removed by the overseas parent banks if the New Zealand bank was considered to be in any trouble. The legalisation of covered bonds in New Zealand is also a serious concern to FIRST Union, as these will allow investors assets to protected from the liquidator and will reduce the assets available to meet the claims of small investors and ordinary depositors. The losses could also fall onto taxpayers if a guarantee is provided. FIRST Union notes such bonds are banned in most comparable countries and their existence does appear to run contrary to the policy efforts of the Reserve Bank. Bertram and Tripe identify six other categories of assets that could turn out to be missing when the liquidator comes looking. These include

- Loans that have been sold to parent banks
- Registered mortgage backed securities
- Repurchase agreements (with wholesale deposit counterparties)
- Assets pledged as collateral for derivatives and other exposures
- Derivative and intangible assets.

3.7. Bertram and Tripe (2012) conclude that:

*“The situation at present seems to be that by carefully structuring a wide range of transactions, and by arranging to have parents and associated parties as counterparties, an overseas-owned New Zealand bank can potentially pre-position itself so open bank resolution would become simply the occasion for large scale stripping out of the best-quality assets by the Australian parent.”*

They suggest that a rule be introduced that if an overseas owned banks’ credit rating fell to BBB+ or below, reflecting an increased risk of failure, their assets in New Zealand should be strictly ring-fenced under the supervision of Reserve Bank appointed accountants to prevent any looting from a New Zealand subsidiary. This would also fit with the requirement suggested by the Reserve Bank that where a bank is part of a larger banking group, the ownership and control of the data used to calculate the New Zealand bank's regulatory reporting position must reside with the New Zealand bank. FIRST Union believes both these proposals are worth serious consideration.

3.8. FIRST Union is also concerned that current Australian law gives priority to Australian customers having first call on the funds and places restrictions on the claims of overseas customers. While Westpac claims the Westpac Banking Corporation Act 1982 offers protection for customers, it is not clear whether New Zealand or Australian law would take precedence in the event of a bank finding itself in financial trouble.

3.9. Without the requirement to carry on business in a prudent manner meaning "within New Zealand" a parent company's main priority in a failure situation would be to manage the impact on the 'group' first, and the New Zealand entity second.

3.10. The Australian banks have also lobbied strongly for regulation to be taken out of the hands of the Reserve Bank and given over to bodies such as the Trans-Tasman Council on Banking Supervision. The banks gained ground during the 2006 Australia New Zealand bilateral where it was agreed to implement legislative changes recommended by the Council. This has relevance for the outsourcing debate because the resulting legislation, The Reserve Bank Amendment Act 2006, defines "a detrimental effect on financial system stability in Australia" to include "an action that prevents or interferes with an outsourcing arrangement." FIRST Union regards this as an extraordinarily one sided definition in that it seemly only applies to proposals from the Australians banks to outsource, and it fails to recognise that certain outsourcing arrangements could have detrimental impact on the financial stability in New Zealand.

3.11. Given the dominance of Australian owned banks in the New Zealand financial system the role of Australian banking and financial sector regulators also needs to be considered. In June 2014 the Economic References Committee of the Australian Senate released a highly critical report on the performance of the Australian Securities and Investments Commission (ASIC). It found "ASIC has limited powers and resources but even so appears to miss or ignore clear and persistent early warning signs of corporate wrongdoing or troubling trends that pose a risk to consumers." It described the response of ASIC to emerging evidence of malpractice in the Commonwealth Bank of Australia (owner of ASB) as that of "a timid, hesitant regulator, too ready and willing to accept uncritically the assurances of a large institution that there were no grounds for ASIC's concerns or intervention" (The Senate Economics References Committee, 2014; Kelsey, 2015, p. 79)

## 4. The benefits of outsourcing can be vastly exaggerated

4.1. A report by Deloitte in 2005 highlighted how global companies have unrealistic expectations of the cost savings that can be gained from outsourcing. Donal Graham, a partner in Deloitte's consulting practice highlighted that to "manage the contract actually takes a lot of in-house capability, and a lot of organisations have failed to really understand this" (Ruth Williams, 2005). Ruth Williams in the Melbourne Age highlighted how the Australian banks push to outsource was seen as a way of bringing down cost-to-income ratios, one again highlighting the importance of short term financial goals to the Australian banks.

4.2. In considering the overall costs and risks of outsourcing not only does the impact of the initial outsourcing of an operation need to be taken into account, but the ongoing impacts of changing suppliers over the long term. If there is little risk of a supplier being changed once they are in place this can undermine the whole 'competitive' point of outsourcing in the first place. Each change of supplier then creates risk of the loss of jobs as well as the loss of significant institutional knowledge.

4.3. The unfortunate fate of the clothing retailer Postie Plus provides a recent example of the dangers of outsourcing. In August 2013, Postie Plus posted a $2.56m loss for the six months ending Feb 2013 and found itself in breach of its banking covenants, a failure management saw as mainly due to the problems following the outsourcing of the distribution systems of the company (Berry, 2013). Postie Plus was bought out of receivership by South African retailer Pepkor (Meier & Nippert, 2014). Given that the banks appear to quickly write off the possibility that they themselves may face insolvency or liquidity issues, its worth nothing they are often the first party who question the insolvency of others.

## 5. Outsourcing policy process

5.1. In relation to functions not generally considered relevant for the outsourcing policy, we suggest these exclusions are kept as specific as possible, and if there were any doubts as to whether a proposal fell under an exclusion then we believe it should be considered by the RB proposed process. If there are few issues then one would expect a non-controversial outsourcing arrangement would presumably have few problems being accepted by the Reserve Bank once it had had been considered by the RB proposed process. In particular we would be concerned if the exclusion for 'telecommunication services' could be construed to mean the operation of a call centre. Nor would we like the exclusion for 'contract personnel' to act as an encouragement to the banks to make further attempts to casualise their workforce.

5.2. FIRST Union strongly supports the establishment of a formal record of outsourced arrangements, however we disagree that none of this information should be made public. If the Reserve Bank expects members of the general public to be canny investors about where they decide to put their money, why withhold information relevant to assessing the financial stability of a bank? Such a commitment to secrecy appears to be contrary to the purpose and spirit of the Official Information Act. Transparency would be enhanced by a requirement that key information about outsourcing arrangements by the banks be made public proactively. The suggested table for the 'compendium' of outsourcing arrangements (Appendix 2) does not appear to cover any information that could be considered commercially sensitive.

5.3. Given that the Reserve Bank has raised a concern regarding the extent of compliance of banks with the existing outsourcing policy we believe it is important that banks provide information about any proposed outsourcing arrangements before entering into the arrangement. Perhaps there should be a mechanism for the

Reserve Bank to require a potentially contentious proposal to be immediately considered under the more detailed provisions of Option One. We believe there should be a provision for banks to provide information on existing outsourcing arrangements, and there should be penalties if banks enter any commitments to an outsourcing arrangement prior to gaining approval from the Reserve Bank.

5.4. FIRST Union supports the lowering of the threshold for outsourcing capture to retail deposits above NZ$1 billion, so long as no banks with high NZ liabilities but low retail deposits could conceivably fall out of the definition of systematically important banks.

## 6. Key Points

6.1. FIRST Union calls on the Reserve Bank to set clear policy and expectations for banks on outsourcing arrangements. We would not like to see the policy or oversight effectively watered down.

6.2. While there is a role for cooperation with the Australian banking regulators, we believe regulation of banks operating in New Zealand needs to stay with the New Zealand Reserve Bank as it is possible to envisage situations where the interests of Australian and New Zealand regulators, as well as the interests of New Zealand regulators and overseas owned banks would diverge.

6.3. The benefits of outsourcing can be exaggerated at the same time its true costs are underappreciated. There is a danger that outsourcing proposals effectively prioritise short term financial goals while presenting risks both to the longer term sustainability of the institution and the soundness of the financial system.

6.4. The value of local and institutional knowledge within the banking system can be an overlooked and undervalued resource. Widespread use of outsourcing can undermine the retention of such knowledge. This can affect the ability of banks to recognise stress in an institution and to learn from previous failings. Such knowledge can be essential in the context of a crisis.

**Joe Hendren**
**FIRST Union Researcher**
[redacted]

**Robert Reid**
**General Secretary**
**FIRST Union**

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