Attachment to Joint Bank Submission

Reserve Bank policy on outsourcing: An assessment of the policy and suggested modifications

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Introduction

1. In May this year, the Reserve Bank of New Zealand (RBNZ) released a consultation paper on outsourcing proposals for application to registered banks: "*Consultation paper: Revised policy proposals for the review of the outsourcing policy for registered banks*" (2016 CP). The paper set our revised proposals for outsourcing requirements. It followed an initial consultation paper issued in August 2015: "*Consultation paper: Review of the outsourcing policy for registered banks*" (2015 CP).

2. The four Australian-owned banks operating in New Zealand[2] have requested Mortlock Consultants Limited to prepare a paper to be attached to their submission to the RBNZ on the outsourcing proposals set out in the 2016 CP. The banks requested that the paper provide analysis of a number of matters to assist in their submission:

   a. A summary of international principles and practice in areas relevant to bank resolution planning and the treatment of critical shared services.

   b. An assessment of the RBNZ's proposals and recommendations for modifications to the proposals where appropriate, taking into account policy objectives and international principles and practice.

   c. A summary of the ways by which the New Zealand banking system has been strengthened since the global financial crisis and the importance of ensuring that policies designed to deal with bank distress or failure take this into account so as to avoid solutions that impose costs which are disproportionate to the problems being addressed.

3. This paper has the following structure:

   - Executive Summary.
   - Assessment of the RBNZ outsourcing policy and suggested changes
   - Appendix I - International principles and practice on bank resolution.

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[2] ANZ Bank New Zealand Limited, ASB Bank Limited, Bank of New Zealand and Westpac New Zealand Limited.

- Appendix II – Summary of initiatives taken to strengthen the New Zealand and Australian banking systems.

Executive Summary

This paper makes a number of findings in relation to the RBNZ outsourcing proposals:

a. The RBNZ's outsourcing proposals are based on resolution objectives that are too narrow and do not adequately reflect either the resolution objectives set out in international principles on bank resolution or in the Memorandum of Cooperation on Trans-Tasman Bank Distress Management (MOC) entered into between the New Zealand and Australian authorities. As such, the proposals go beyond what is necessary to meet appropriate resolution objectives and would impose unacceptably high costs on the affected banks and significant adverse efficiency outcomes for the New Zealand financial system.

b. The outsourcing proposals are based on a conflated set of objectives that mix resolution with risk management objectives. Unlike most advanced country supervisory authorities, the RBNZ lacks a generic outsourcing policy applicable to all banks; it has focused outsourcing only on large banks and principally for a narrow set of resolution objectives. This has not only led to an inadequately conceived outsourcing policy but has also resulted in a competitively non-neutral approach to outsourcing across the banking sector. If implemented, the policy would result in unnecessarily onerous outsourcing requirements for the large banks and no explicit requirements for other banks.

c. The proposals have been developed on a presumption of the New Zealand bank subsidiaries being separated from the parent banks, with no analysis being undertaken as to alternative resolution options – particularly whole-of-group resolution involving 'Single Point of Entry' (SPE). Although separation is a possible resolution option, it is likely to be less effective than would a whole-of-group SPE resolution in meeting financial stability objectives, would likely increase the recapitalisation costs of the subsidiary (and hence increase the level of haircut required under OBR), would likely increase New Zealand taxpayer risks, increase contagion risk and impose higher compliance costs and adverse efficiency outcomes.

d. If a separation form of resolution is desired, this does not require the kind of outsourcing restrictions being proposed by the RBNZ. Instead, the focus should be on arrangements that facilitate continuity of critical shared services and functions. This can be achieved with such services and functions being located in the parent entity or other related parties, subject to a number of requirements being met. The RBNZ proposals are unnecessarily expensive and give rise to a range of operational risks.

e. The RBNZ proposals appear not to have been undertaken in close coordination with the Australian authorities and do not accord with the internationally accepted principle of cross-border cooperation and coordination. They also sit uncomfortably with the Trans-Tasman MOC, which contemplated a close degree of coordination in the development of resolution plans. As a result, the proposals reflect a very sub-optimal set of resolution arrangements – for New Zealand as a whole, the New Zealand taxpayer, the banks and bank customers.

f. The RBNZ proposals have not been developed in accordance with a transparent and robust set of policy assessment criteria, including cost/benefit analysis. This has resulted in unsatisfactory policy development and an unacceptable degree of transparency and accountability.

The paper recommends that:

a. The RBNZ develop a generic outsourcing policy applicable to all banks on a competitively neutral basis that is based on conventional outsourcing policy objectives (similar to that applied by APRA and many other supervisory authorities), focused on ensuring sound risk management within banks.

b. The RBNZ's resolution-related policies, including the treatment of critical shared services and functions, be based on a more comprehensive and internationally consistent set of resolution objectives that focus on financial stability, avoidance of unnecessary costs and loss of value, minimisation of taxpayer risk and moral hazard, and close coordination of cross-border bank resolution.

c. Resolution policies, including in relation to outsourcing, for the four major Australian banks should be undertaken in close cooperation and coordination between the Australian authorities (principally APRA and the Commonwealth Treasury) and the New Zealand authorities (principally the RBNZ and NZ Treasury). Resolution planning for the Australian banks should not be based on a presumption of separation of the NZ subsidiaries from their parent banks. Rather, it should involve consideration of both SPE and 'Multiple Points of Entry' (MPE) options, including cost/benefit analysis of each, and an identification of the prepositioning required for each.

d. Once generic cross-border resolution strategies and plans have been developed by the New Zealand and Australian authorities, jointly, the authorities should establish Crisis Management Groups for each of the four major banks to oversee the development of bank-specific resolution plans.

e. Resolution planning in relation to critical shared services and functions should focus on the means by which continuity of shared services and functions can best be assured in the event of a parent bank/related party failure or separation of the subsidiary from the parent. The optimal solution is unlikely to require ex ante separation of critical functionality from the parent group or back-up arrangements that sit outside the group. More cost-effective solutions are likely to involve a combination of measures, including:

   i. legally documented service level agreements that comprehensively set out rights and obligations, performance requirements, back-up and testing requirements, pricing, prevention of default relating to entry into resolution, and a requirement to treat all service recipients equally;

   ii. requirements as to the legal entity(ies) that provide critical shared services, including governance, ownership and funding, where the NZ subsidiary has a reasonable level of either co-ownership or control of the entities (but where the entities can be within the parent group);

   iii. a resolution plan that sets out the means by which critical functionality can, within a reasonable period of time following separation, be established in the NZ subsidiary if a separation form of resolution has been implemented, on the basis that, in the interim period, the parent bank continues to provide critical functions and services under service level agreements, backed by statutory obligations;

iv. the establishment of a statutory framework, enacted in New Zealand and Australia, that facilitates APRA and RBNZ mutual support and legal recognition and enforcement of cross-border resolution actions where such support and recognition/enforcement is consistent with the resolution objectives in both countries;

v. the establishment of a statutory framework that requires APRA to ensure that parent banks and related parties under their jurisdiction continue to perform under SLAs, including in resolution situations, pending the implementation of separation arrangements where a separation form of resolution is to be implemented.

f. The current outsourcing proposals be placed on hold until cross-border resolution planning arrangements are well advanced. Placing the proposals on hold would also enable the Minister of Finance, Treasury and RBNZ to assess policy options in light of the analysis and recommendations in the IMF FSAP assessment later this year.

g. The Treasury increase its oversight of the RBNZ in respect of resolution issues, in the context of Treasury's important responsibilities for aspects of bank resolution, to ensure that a whole-of-government approach is taken to bank resolution.

Assessment of the RBNZ outsourcing policy and suggested changes

1. The RBNZ's outsourcing policy, both as currently set out in BS11 and as articulated in revised form in its 2015 and 2016 consultation papers, was developed in the context of the statutory purposes for which the RBNZ may exercise its powers under Part V of the *Reserve Bank of New Zealand Act 1989* (the RBNZ Act). In accordance with section 68 of the RBNZ Act, the RBNZ is required to exercise its powers for the purposes of:

   a. promoting the maintenance of a sound and efficient financial system; and

   b. avoiding significant damage to the financial system that could result from the failure of a registered bank.

2. The RBNZ has stated in its consultation papers that the outsourcing policy is intended to meet both purposes. This recognises that robust outsourcing arrangements, in respect of critical functions that are outsourced, is essential both as a means of promoting the sound management of banking risks and the effective resolution of a failed bank. It is also essential for the recovery of a bank from an adverse operational or financial shock.

3. In substance, however, the RBNZ's outsourcing policy from the outset was primarily about facilitating bank resolution – and in particular a form of resolution that contemplates separation of a New Zealand bank subsidiary from its parent bank. The 2015 and 2016 consultation papers acknowledge this point by explicitly drawing the linkage between outsourcing policy and OBR. The fact that BS11 applies only to the large banks (i.e. those whose New Zealand liabilities, net of amounts due to related parties, exceed NZD10 billion) is also indicative of the resolution focus of the outsourcing policy.

4. In evaluating the RBNZ's proposals on outsourcing, it is helpful to disentangle the policy objectives underlying the proposals. In essence, this involves articulating clear policy objectives for outsourcing per se in relation to the promotion of sound risk management within banks, on the one hand, and the objective relating to facilitating effective bank resolution and outsourcing policy's role within resolution, on the other. The RBNZ approach since 2006, including in its 2015 and 2016 consultation papers, has been to conflate these two sets of objectives. This has made it more difficult to identify the appropriate policy settings for outsourcing. Separating the objectives more clearly can assist in determining the appropriate policy settings.

Generic outsourcing policy

5. The policy objective for outsourcing requirements for banks (leaving aside resolution related issues) should be to ensure that banks' outsourcing risks are managed prudently, consistent with banks being able to manage their business (especially in regard to critical services and functions) in a manner consistent with the maintenance of a sound and efficient financial system and the reasonable protection of banks' depositors and other creditors.

6. To date, the RBNZ has focused its outsourcing policy only on large banks, via the condition of registration set out in BS11. The primary objective of the RBNZ's

outsourcing policy has been in relation to ensuring a reasonable degree of local control of a large bank's functions relating to clearing and settlement, risk management and customer access to payment facilities. In contrast to most foreign supervisory authorities, the RBNZ has not had an explicit generic outsourcing policy applicable to *all* registered banks.

7. In contrast to the RBNZ's focus on large banks, and the primarily resolution-focused approach to outsourcing policy, most supervisory authorities in advanced economies have generic outsourcing requirements that apply to *any* licensed bank. For example, APRA's *Prudential Standard CPS231 – Outsourcing* applies to all Authorised Deposit-taking Institutions (ADIs) and other regulated entities. It states the objectives of outsourcing as being: "*All risks arising from outsourcing material business activities must be appropriately managed to ensure that the regulated institution is able to meet its financial and service obligations to its depositors and/or policyholders*." Many other supervisory authorities have similar approaches to outsourcing, where the focus of the policy is on ensuring robust management of outsourcing arrangements to ensure that risks are prudently managed.

8. It would be helpful if the RBNZ could design a generic outsourcing policy which applies to all banks and anchors to the objective of ensuring that outsourcing arrangements are managed prudently by banks to enable them to manage their risks in a manner consistent with the maintenance of a sound and efficient financial system and to provide continuity of functions in the event of operational or financial shocks affecting the service provider. This would then enable the RBNZ to set out additional outsourcing requirements for the resolution of systemically important banks that focus principally on resolution policy objectives. Disentangling the policies would be helpful because it would enable outsourcing policies to be more clearly linked to policy objectives. It would also help to underpin greater competitive neutrality of policy across banks, with all banks being subject to a generic set of outsourcing requirements and systemically important banks being subject to an overlay of requirements intended to facilitate effective resolution.

Objectives for resolution policy

9. The primary driver of the RBNZ's outsourcing policy has been resolution policy. This reflects the RBNZ's desire to ensure that it can resolve banks in a manner consistent with section 68 of the RBNZ Act – i.e. to "avoid significant damage to the financial system that could result from the failure of a registered bank".

10. It is entirely appropriate for the RBNZ to establish specific resolution policy objectives and to ensure that banks' outsourcing arrangements (especially those of systemically important banks) are consistent with meeting these objectives. In that regard, it would be helpful if the RBNZ were to adopt a set of reasonably specific resolution policy objectives that are broadly consistent with international principles (particularly those set out in the Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions*). This would enable the resolution policies and the relevant outsourcing requirements to be better aligned with the resolution objectives.

11. Having regard to section 68 of the RBNZ Act and international principles (such as the Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions*), an indicative set of resolution objectives should focus on:

a. maintaining the stability of, and avoiding significant damage to, the financial system;

b. ensuring continuity of systemically important financial services, and payment, clearing and settlement functions;

c. avoiding where possible damage to the stability of other countries' financial systems (especially Australia's, in accordance with section 68A(1) of the RBNZ Act);

d. avoiding unnecessary costs associated with resolution and resolution prepositioning;

e. avoiding or at least minimising taxpayer risk and moral hazard; and

f. maintaining market disciplines in the banking system.

12. Although the RBNZ's outsourcing policy has been developed to meet resolution objectives, it has been focused principally on a presumption of separation of the New Zealand subsidiary from the parent bank, as opposed to being focused on maintaining continuity of critical shared services and functions – regardless of which resolution option has been selected (i.e. joint parent/subsidiary resolution versus resolution involving separation from the parent bank). In effect, the policy seeks to facilitate *separation*, rather than *separability*. This has led to a policy that imposes excessive costs and creates adverse efficiency outcomes. The policy also appears to overlook the need for, and desirability of, a coordinated home/host approach to resolution that seeks to meet financial stability and efficiency outcomes in both the home and host countries. It also underweights the resolution objective of avoiding unnecessary costs associated with resolution.

13. It is suggested that the RBNZ, in coordination with Treasury, develop a more comprehensive and balanced set of resolution objectives that align to international principles, particularly those set out the FSB Key Attributes.

Assessment of RBNZ outsourcing policy

14. In assessing the RBNZ's proposals on outsourcing, it is helpful to have regard to criteria that are commonly applied to the assessment of regulatory proposals. These criteria in part anchor to the need for the RBNZ to exercise its powers under Part V of the RBNZ Act in accordance with section 68, which includes promoting an efficient financial system. Although the Act does not define 'efficient', and the RBNZ has not publicly elucidated on its interpretation of this element of section 68, it could reasonably be expected that 'efficient' would include such factors as allocative efficiency, productive efficiency and dynamic efficiency, and would take into account compliance costs associated with regulation.

15. Unfortunately, robust analysis by the RBNZ of policy options against assessment criteria has been largely absent from the consultation papers to date. In this regard, it is

suggested that, in the next iteration of the outsourcing proposals for consultation - and *before* any proposals are finalised - the RBNZ provide comprehensive and transparent analysis of its proposals against at least the following assessment criteria:

- Clarity of objectives.
- Clarity of problem definition.
- Extent to which policy proposals are targeted to policy objectives and do not go beyond the objectives.
- Extent to which policy proposals are proportionate to the problem being addressed.
- Compliance costs – initial and ongoing.
- Impact on banks' dynamic efficiency – such as the ability to innovate and respond adaptively and flexibly to changing market conditions.
- Competitive neutrality across banks.
- Consistency with relevant international principles and practice (but taking into account the specific circumstances of the New Zealand financial system).

16. In reviewing the RBNZ proposals, taking into account the above considerations, it appears that the proposals have a number of significant shortcomings that warrant attention. The main shortcomings are summarised below.

Disproportionate costs relative to resolution objectives

17. The proposals in the 2016 CP go beyond what is needed to meet legitimate resolution objectives. Some of the proposed requirements (such as the need for switch-over to back-up facilities within 60 minutes and the prevention of back-up facilities being with a related party) are unnecessary impositions; they are not required to ensure continuity of critical shared services. They entail potentially very high one-off implementation costs and ongoing compliance costs to the banks. These costs would in all likelihood be passed on to customers in New Zealand, thereby increasing the costs of financial services. They also have potentially adverse impacts on bank efficiency, such as the capacity to draw on scale and scope economies available by utilising parent bank operational systems. A further disadvantage associated with the RBNZ proposals is the potential risk of reduced IT security, maintenance and testing to the extent that the banks in New Zealand need to establish their own arrangements in these areas or contract them out to parties outside the parent group.

18. In effect, the RBNZ is proposing a set of functionality arrangements that are costly to implement and maintain, and reduce the efficiency of the banks' operations, based on low probability events (i.e. the failure of parent bank and subsidiary) and on a presumption that separation of the subsidiary from the parent bank is the optimal resolution strategy. The RBNZ appears to discount the alternative resolution options, particularly of keeping the subsidiary in the parent group via a SPE form of resolution. It also seems to attach no or little weight to the alternative means by which functionality support could be maintained even if it is outsourced to the parent bank or elsewhere in the parent group, such as contractual and statutory obligations on the parent bank and parent authorities to ensure continuity of functionality.

Presumption of separation

19. The RBNZ's policy is based on a presumption of separation of the New Zealand subsidiary from the parent bank. This should not be the starting point for, or focus of, outsourcing policy for resolution purposes. Rather, resolution policies, including in relation to critical shared services and functions, should be developed having regard to the two generic resolution options applicable to complex banking groups:

- 'Single Point of Entry' (SPE), where the group is kept intact and capital is cascaded from the parent to the subsidiary; and

- 'Multiple Points of Entry' (MPE), where the group could potentially be broken up and the subsidiary resolved separately from the parent (although some MPE options can be structured to keep the group intact).

20. It makes no sense to design resolution policy with a presumption of separation of the subsidiary from the parent group unless that resolution option offers the best prospects to meet resolution objectives at least cost and risk. In all likelihood, a separation form of resolution will not do this. Indeed, separation would most likely impose greater recapitalisation costs and the need for a deeper haircut on liabilities of the subsidiary, would impose more severe recapitalisation costs on the parent bank, would increase contingent risks to the New Zealand government and would increase the risk of financial instability in New Zealand. A stand-alone, separated bank would require much higher capitalisation than would a subsidiary retained in the parent group. It would also find it more difficult to retain a reasonable credit rating and to access funding in the markets. As such, it would require greater support from the New Zealand Government than if it were retained in the parent group and recapitalisation via a SPE form of resolution.

21. A policy based on a presumption on separation also creates risks of contagion, both within New Zealand and Australia. Contagion risk is much more likely to arise if depositors and counterparties believe that separation is the default option of the RBNZ, given that it would likely result in a deeper haircut and greater uncertainty for creditors. Once a MPE solution is imposed on one bank, it creates a significant risk of contagion to other banks, both in the form of deposit runs and withdrawal of counterparty support. The absence of deposit insurance in New Zealand compounds this risk.

Questionable assumptions about parent bank incentives to provide continued functionality support to subsidiaries

22. Part of the problem with the RBNZ approach is its assumptions in relation to parent bank functionality support. The RBNZ has long operated on an assumption that the parent banks would have little incentive to continue to provide functionality support to their subsidiaries in New Zealand. They have also assumed that the Australian authorities could not be relied on to ensure that functionality support is continued in a situation where the parent bank is under the control of a statutory manager. These assumptions are questionable. In particular:

    a. There is no reason to assume that a parent bank would have no commercial incentives to maintain functionality support to its New Zealand subsidiary. Quite the contrary assumption is much more plausible – i.e. that the parent bank would have strong commercial incentives to continue to provide functional support (assuming the services in question are priced at market or on a reasonable rate of return basis). The following points support this view.

i. If the parent bank is commercially sound, but the New Zealand subsidiary has sustained a major loss of capital and liquidity, it is likely that the parent bank would provide the required capital and liquidity support, together with continued functionality support, to the subsidiary in order to preserve franchise value and shareholder value of the subsidiary, and to minimise reputation risk to the parent. So long as the parent bank can inject capital and liquidity into the subsidiary without jeopardising the parent bank's own capital and liquidity position, it is highly likely that APRA would give its approval to the support arrangements.

ii. If the parent is not sufficiently capitalised to provide capital and liquidity support to the New Zealand subsidiary, but the parent has not itself failed, then APRA might prevent the parent from providing capital and liquidity support, but it would be very unlikely to prevent the parent from continuing to provide functionality support. This is because APRA would wish to minimise the extent of shareholder loss to the parent bank (given APRA's desire to ensure that the parent bank remains financially sound), and would wish to minimise reputation damage and contagion to the parent bank. Discontinuing functionality support to the New Zealand subsidiary would not be in the interests of the parent banking group or Australia's financial stability. Rather, the incentives would favour continuing functionality support for so long as is required to extricate the New Zealand subsidiary from the parent banking group and to establish localised functionality.

b. In a parent bank failure scenario, the Australian authorities do not have incentives to impede the parent bank's continued functional support to the New Zealand subsidiary. Quite the opposite is the case. The Australian authorities would wish to keep the group intact where possible, given that this would be likely to lower the losses for the parent bank (assuming that there is still franchise value in the New Zealand subsidiary) and thereby reduce the parent bank recapitalisation requirement (whether this is funded by the Australian government, by creditors in a bail-in at parent level or by third party private sector sources). The Australians would probably seek to implement a SPE form of resolution, with the agreement of the New Zealand authorities, under which the parent bank is capitalised sufficient to restore the parent and parent group to financial soundness, with capital being cascaded to the New Zealand subsidiary via the parent. They would doubtless seek a New Zealand contribution to the recapitalisation of the parent to the extent of the capital cascaded to the New Zealand subsidiary. That contribution could be via the New Zealand government (which could recover any funding outlays via a levy on banks in New Zealand if not fully recovered from the resolved bank over time). Alternatively, it could be funded via a bail-in of liabilities of the New Zealand subsidiary, such that the creditors receive capital instruments in the parent bank and the parent bank cascades capital to the subsidiary. In any of these scenarios, the aim of the Australians would be to maintain the functional capacity of the New Zealand subsidiary.

c. Even if the New Zealand authorities decline to participate in a SPE form of resolution, and instead opt to either implement OBR (and issue shares in the subsidiary to 'haircut' creditors) or to recapitalise the New Zealand subsidiary via a government-funded capital injection, the Australian authorities have strong incentives to enable the parent bank to maintain functional support to the New Zealand subsidiary – including following it ceasing to be a subsidiary – until such time as the subsidiary can establish its own stand-alone functionality.

There are several reasons for this. First, the Australian authorities would want to minimise reputation damage to the parent bank, given that they want the parent bank to maintain market confidence post-resolution. Discontinuing functionality support to the New Zealand subsidiary would almost certainly damage the parent bank's reputation in the markets and weaken investor and counterparty confidence in the parent bank. Second, the Australian authorities would wish to minimise intra-group contagion (e.g. runs on the parent bank's other foreign operations) that could easily arise if the parent bank cut off functional support from its New Zealand subsidiary. Third, the Australian authorities would want to minimise the potential contagion risk to other parent banks in Australia; they would want creditors of the New Zealand subsidiaries of the other Australian parent banks to remain confident that the New Zealand operations will continue as normal. Fourth, the Australian authorities would want to avoid counter-defensive measures by New Zealand in respect of the other Australian banks in New Zealand, such as sharp increases in local capital requirements, ring-fencing and forced in-sourcing of critical functionality (if in-sourcing had not already been required).

23. Overall, therefore, the RBNZ's assumptions about likely Australian parent bank and authority actions are difficult to sustain in any plausible scenario. This not mean that all aspects of their outsourcing policy are unfounded. Nor does it suggest that OBR is misplaced as an option in the resolution toolkit. However, it does suggest that the bias against outsourced functionality residing in the parent or parent group is ill considered. And it also suggests that the starting point in their policy – i.e. of separating the New Zealand subsidiary from the parent bank in a resolution – is highly questionable.

Lack of whole-of-government approach to resolution

24. The RBNZ approach lacks any indication that the New Zealand Treasury has been actively engaged in the resolution planning process. Given that any form of resolution will likely involve some form of government support, and a resolution strategy based on a presumption of separation will likely entail a greater degree of government support, it is imperative that Treasury is closely involved in the resolution planning process. Moreover, the fact that the selection of resolution strategy (including the decision to appoint a statutory manager) rests not with the RBNZ but with the Minister of Finance reinforces the need for Treasury to be closely involved in resolution planning for the major banks. A whole-of-government approach is needed.

Lack of cross-border coordination

25. The RBNZ approach also suggests that there has been little coordination with the Australian authorities. Close cross-border coordination with the Australian Treasury and APRA is essential and indeed would be an orthodox approach in most advanced

economies, as indicated in the Key Attributes and as displayed by most of the EU jurisdictions, US and some Asian countries. The absence of close domestic and cross-border coordination creates a risk of inadequate resolution planning and gives rise to a major risk of resolution outcomes that are more costly, less efficient and less effective in meeting the systemic stability objectives of New Zealand and Australia.

26. It is notable that the Trans-Tasman MOC explicitly contemplates a strong degree of coordination between Australia and New Zealand in resolution planning, yet seems to have been substantially ignored by the RBNZ's go-it-alone approach. Note that, among other matters, the Trans-Tasman MOC states that: "*A co-ordinated, co-operative approach involving the participants is likely to lead to a more cost-effective financial crisis resolution and a more effective means of maintaining financial system stability in both countries than one in which the respective participants pursue separate agendas. The participants will therefore seek to cooperate, where practicable, in respect of all stages of resolving a crisis situation, including problem identification; information sharing; systemic impact analysis; assessment of response options; implementation of resolution; public communication; and exit strategy*."

Incomplete approach to recovery and resolution planning

27. The RBNZ's proposal for banks to prepare separation plans is reasonable. However, these should be integrated into much wider-ranging recovery plans and (separately) resolution plans. The recovery plans should set out the means by which the banks would restore themselves to financial soundness in the face of a parent-based or local financial shock. Separation is unlikely to form part of a recovery strategy, but could be part of it as a fall-back if whole-of-group recovery proves to be unachievable. The resolution plans should set out the resolution processes and prepositioning needed to achieve SPE and MPE resolution options; there should be no presumption of a stand-alone separation outcome, but separability should be included in the resolution plan. Accordingly, the RBNZ's proposals fall well short of the international standards in respect of both recovery planning and resolution planning.

Suggested modifications to the proposals

28. In view of the above observations, I suggest a number of modifications to the proposals, as follows:

    a. The RBNZ should specify resolution objectives that it will apply to all of its resolution-related policies, along the lines set out in the Key Attributes and referred to earlier in this paper. These objectives should guide the resolution-related elements of outsourcing requirements (as applied to the large banks and realistically to any bank required to be prepositioned for OBR). These objectives should also apply to OBR policy and other resolution policies.

    b. The RBNZ should develop its outsourcing policies and all other resolution related policies in close coordination with Treasury and with the Australian authorities. The cross-border coordination should occur within the framework of the MOC and should seek to ensure that resolution strategies and plans are developed in a manner consistent with meeting both New Zealand and Australian resolution policy objectives to the extent practicable, and in a manner consistent with the Key Attributes and with section 68A of the RBNZ Act.

c. Recovery and resolution planning for the four major banks should not start from a presumption of separation of the subsidiary from the parent bank. Rather, the recovery and resolution plans should embrace both SPE and MPE options, identifying the requirements of each. The costs and benefits of SPE and MPE options should be fully assessed, with a view to seeking to achieve the resolution options that offer the best prospects to deliver financial stability outcomes in both countries at least cost to the banks and least contingent risk to the taxpayers of both countries.

d. Coordination between the RBNZ and Treasury should be undertaken within the forum of the CoFR, with participation of the FMA as appropriate, possibly by way of a working group established for the purpose. The banks should participate in some of the meetings with officials to ensure that technical issues requiring bank expertise are properly integrated into the resolution planning process.

e. Coordination between the New Zealand and Australian agencies should occur via a working group of the Trans-Tasman Council on Banking (or whatever it is now called), under the umbrella of the Trans-Tasman MOC.

f. SPE and MPE costs and benefits should be comprehensively assessed, including with respect to financial stability outcomes, recapitalisation costs, depth of bail-in costs, contingent government risks, resolution funding implications, compensation arrangements to meet the 'no creditor worse off' test, contagion risk, compliance costs and efficiency outcomes.

g. Once generic SPE and MPE resolution options have been developed, with prepositioning identified, bank-specific resolution plans could then be developed via Crisis Management Groups for each bank.

h. Separation planning requirements should be subsumed within bank recovery and resolution planning requirements and should cater to a full range of recovery and resolution options, including SPE and MPE.

i. The outsourcing requirements should be modified to remove the need for any ex ante separation of outsourcing functionality (including back-up functionality) from the parent bank group, and instead be replaced with requirements along the following lines:

   i. Robust legal documentation of all SLAs in respect of critical shared functionality, including clear specification of rights and obligations of all parties, clearly specified events of default, remedy provisions, performance requirements, pricing, and prevention of termination or suspension merely because a bank or other entity has been placed into statutory management or other form of resolution, provided that financial obligations under the SLA continue to be met.

ii. An obligation on the service provider to treat all recipients of the services performed equally – i.e. no preferential treatment for any counterparties.

iii. Requirements relating to the legal structure, governance and funding arrangements of the service provider within a parent group, such that the NZ subsidiary either has co-ownership of the service provider or board representation, and a reasonable degree of control over the performance requirements of the service provider.

iv. Contractual obligations on the parent banks (or ultimate holding companies) and other relevant entities in a position of control over the providers of critical shared functionality to provide any financial and operational support to such providers to enable them to continue to perform their obligations under SLAs, notwithstanding the entry into resolution of any part of the banking group, provided that the entity receiving services under an SLA continues to meet their obligations under the SLA.

v. A requirement that all critical shared services performed within the parent banking group are subject to back-up and testing arrangements as agreed by APRA and RBNZ jointly, with RBNZ given the same rights of examination of such arrangements and the capacity to require audit and testing, as APRA.

vi. Consideration of a new statutory framework, enacted in Australia and New Zealand, that empowers APRA and RBNZ, respectively, to give legal recognition and enforcement to resolution actions to be undertaken by APRA/RBNZ (as the case may be) in their respective jurisdictions, provided that they are satisfied that the resolution action in question is consistent with the resolution objectives of their respective jurisdiction.

vii. In the context of the preceding point, establishment of a statutory obligation on APRA to require a parent bank and any entity under the control of a parent bank to perform all obligations under SLAs to ensure continuity of critical shared services in New Zealand, provided that the New Zealand entity receiving the service performs its obligations under the SLA.

viii. Identification of a process for facilitating separation of a New Zealand subsidiary from the parent banking group if an MPE resolution option is selected, such that critical shared functionality would be maintained uninterrupted to the bank in New Zealand (or a bridge bank) until such time as the functionality needed to enable the bank to operate on a stand-alone basis has been established in the bank locally.

ix. A requirement that the board and management of the NZ subsidiary retains responsibility for ensuring that the services that have been outsourced are being performed, and can continue to be performed, to a level that meets defined risk management outcomes in respect of the services in question. This would suggest the need for a specification of operational risk outcomes and minimum performance standards that the board of the subsidiary specifies and that it attests to compliance with in respect of any outsourced services.

x. The board and management of the NZ subsidiary being satisfied that any outsourcing arrangement meets specified policy with respect to internal controls relating to the outsourced services. This might include, for example, the need for the board and management to establish frameworks for the regular testing of the outsourced services or to require, under SLAs, that the service provider undertakes regular testing in accordance with agreed specifications. It might also suggest the need for the NZ subsidiary to require periodic internal audit and/or external audit of the services and their compliance with internal controls and KPIs, in accordance with audit requirements set out in SLAs.

xi. The NZ subsidiary requires there to be robust back-up arrangements for any outsourced services (which, in my view, could be the same back-up arrangements that the parent entity also requires for the services in question – I see no reason why back-up arrangements need be outside the parent group so long as the back-up arrangements are robust, legally documented, regularly tested, etc).

29. In view of the above points, and in light of the fact that the IMF FSAP assessment later this year will doubtless provide insights and recommendations in relation to resolution planning, OBR and trans-Tasman coordination issues, I think it would be appropriate for the RBNZ's outsourcing proposals to be placed on hold until after the IMF recommendations have become known and until the domestic and trans-Tasman coordination processes have been progressed to a reasonably advanced stage.

Appendix I

International principles and practice on bank resolution

1. Since the global financial crisis, there has been a wide array of international guidance on bank resolution, including cross-border recovery and resolution planning. This has led to many jurisdictions undertaking major reforms of their bank resolution frameworks. This appendix discusses the international developments of particular pertinence to the RBNZ outsourcing and OBR proposals.

2. The main international standard-setting body that has led the global reforms on bank resolution is the FSB. The FSB has released a great deal of guidance on bank resolution issues. The principal document, which now takes the form of an international standard on resolution, is the *Key Attributes of Effective Resolution for Financial Institutions* (Key Attributes)[3]. Although the Key Attributes was designed for particular application to globally systemically important financial institutions (G-SIFIs), it has become the principal international standard applicable to bank, insurance and FMI resolution per se. As such, countries are being informally evaluated by reference to the Key Attributes by the IMF and World Bank in the regular Financial Sector Assessment Program (FSAP) country assessments. New Zealand will be subject to such an assessment later this year.

FSB Key Attributes

3. The Key Attributes set out a comprehensive set of guidance on the elements required for effective bank recovery and resolution. Among other matters, the Key Attributes provide guidance on:

   - the objectives of bank resolution;
   - the scope of a resolution framework (in terms of the need, for example, for resolution powers to apply to holding companies, banks and all entities within a banking group other than those outside the regulated group);
   - the need for a resolution authority that has operational independence and is subject to robust accountability and transparency arrangements;
   - the need for the resolution authority to have comprehensive resolution powers;
   - safeguards, including that the law ensures that no creditor (or shareholder) will be rendered worse off under a resolution than they would have been under conventional legal entity insolvency procedures;
   - resolution funding arrangements;
   - the legal and practical elements of cross-border coordination;

[3] See http://www.fsb.org/2014/10/r_141015/

- the need for home and host authorities to establish Crisis Management Groups (CMGs) to coordinate recovery and resolution planning for cross-border banking groups;

- recovery planning (i.e. plans prepared by banks that set out the means by which they would restore themselves to financial and operational soundness following a capital or liquidity shock);

- resolvability assessments (which are prepared by the resolution authority to assess the options for resolving a complex bank and the potential obstacles to resolution); and

- resolution plans (which are prepared by the resolution authority and set out the means by which a non-viable bank could be resolved cost-effectively).

4. Some of the points covered in the Key Attributes are worth expanding on, given their relevance to the outsourcing issues.

Resolution objectives

5. The Key Attributes note that resolution regimes should:

- ensure continuity of systemically important financial services, and payment, clearing and settlement functions;

- protect, where applicable and in coordination with the relevant insurance schemes and arrangements such depositors, insurance policy holders and investors as are covered by such schemes and arrangements, and ensure the rapid return of segregated client assets;

- allocate losses to firm owners (shareholders) and unsecured and uninsured creditors in a manner that respects the hierarchy of claims;

- not rely on public solvency support and not create an expectation that such support will be available;

- avoid unnecessary destruction of value, and therefore seek to minimise the overall costs of resolution in home and host jurisdictions and, where consistent with the other objectives, losses for creditors;

- provide for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution;

- provide a mandate in law for cooperation, information exchange and coordination domestically and with relevant foreign resolution authorities before and during a resolution;

- ensure that non-viable firms can exit the market in an orderly way; and

- be credible, and thereby enhance market discipline and provide incentives for market-based solutions.

Resolution planning

6. Another important part of the Key Attributes is resolution planning – i.e. the plans that the resolution authorities should put in place to identify how they would resolve a bank that is no longer viable and that cannot restore itself to viability through recovery actions. A resolution plan is intended to facilitate the effective use of resolution powers to protect systemically important functions, with the aim of making the resolution of any bank feasible without severe disruption and without exposing taxpayers to loss. It should include a substantive resolution strategy agreed by officials and an operational plan for its implementation. In particular, a resolution plan should identify:

- financial and economic functions for which continuity is critical;

- suitable resolution options to preserve those functions or wind them down in an orderly manner;

- data requirements on the firm's business operations, structures, and systemically important functions;

- potential barriers to effective resolution and actions to mitigate those barriers;

- actions to protect insured depositors and insurance policy holders and ensure the rapid return of segregated client assets; and

- clear options or principles for the exit from the resolution process.

7. The Key Attributes differentiate between two main forms of resolution for resolution planning purposes for banks that are part of groups: 'Single Point of Entry' (SPE) and 'Multiple Points of Entry' (MPE). SPE is where a banking group is resolved via the head of the group, such that capital is injected into the head of the group sufficient to recapitalise the parent bank and any bank subsidiaries within the group to the required level. Capital is provided either through bail-in of liabilities issued by the head of the group (or conceivably bail-in of liabilities at lower-level entities in the group) or through an injection of capital from the government or a third party. MPE is where the recapitalisation of each bank in the group occurs at the level of the individual bank. Again, it is funded via bail-in of liabilities of the bank in question or injection of capital by government or third party.

8. SPE has the merit of keeping the banking group intact, with subsidiaries remaining within the parent group. However, it raises questions over burden sharing between home and host jurisdictions, unless recapitalisation occurs via bail-in at local level (by issuance of shares in the parent bank). MPE carries the risk of breaking up the group, and requires greater prepositioning to facilitate the ability of the subsidiaries to maintain critical operations once separated from the group.

Cross-border coordination

9. The Key Attributes place much emphasis on the need for close cooperation and coordination between home and host resolution authorities. Much of the Key Attributes is dedicated to this theme, as is more specific guidance developed by the FSB on this matter[4]. In particular, the Key Attributes stress the need for:

- the home supervisory authority and resolution authority working closely with the host supervisory and resolution authority in the development of protocols for cross-border recovery and resolution, recovery planning and resolution planning;

- the finance ministries in the home and host jurisdictions closely coordinating on cross-border resolution issues that involve the exercise of powers by the Minister of Finance/Treasurer and provision of resolution funding;

- the establishment of a supervisory colleges for any systemically important cross-border bank, led by the home supervisor, to facilitate coordination with host supervisors – e.g. in the development of coordinated approaches to day-to-day supervision, and in recovery planning and business continuity planning;

- the establishment of a Crisis Management Group (CMG) for any systemically important cross-border bank, led by the home resolution authority, to coordinate resolution planning and resolvability assessments with host resolution authorities.

10. The FSB, both in the Key Attributes and in other guidance material, stresses the importance of mutual recognition arrangements in cross-border resolution – i.e. the capacity for a host authority to give legal recognition and enforcement in the host jurisdiction to the resolution actions of the home authority, and vice versa. They also stress the need for mutual recognition in the form of support arrangements, such as a home authority or host authority taking actions in their respective jurisdictions to support the resolution actions of the other authority in a cross-border resolution.

FSB Guidance on Arrangements to Support Operational Continuity in Resolution

11. The FSB has also developed guidance in other areas relevant to the RBNZ outsourcing policy and OBR arrangements. Of particular relevance is their consultative document, issued in November 2015, entitled *Guidance on Arrangements to Support Operational Continuity in Resolution*.[5] This paper is directly pertinent to the issues covered in the RBNZ outsourcing proposals, given that it covers critical functions and shared services.

12. The FSB paper proposes that a bank's service model needs to provide operational continuity in the two key stages of resolution:

- stabilisation (i.e. the point at which resolution tools are applied); and

[4] See for example the FSB paper on *Principles for Cross-border Effectiveness of Resolution Actions*, accessible at: http://www.fsb.org/2015/11/principles-for-cross-border-effectiveness-of-resolution-actions/

[5] This document can be accessed at: http://www.fsb.org/2015/11/consultative-document-on-arrangements-to-support-operational-continuity-in-resolution/

- wind-down and/or restructuring (i.e. the period in which the bank is wound down or restructured to create a viable business model).

13. In the paper, critical functions are defined as activities performed for third parties where failure would lead to the disruption of services that are vital for the functioning of the real economy and for financial stability, due to the size or market share of the financial institution or group, its external and internal interconnectedness, complexity and cross-border activities. Critical shared services are activities, functions or services performed for one or more business units or legal entities of the group, performed by either an internal unit, a separate legal entity within the group or an external provider, and the failure of which would lead to the collapse of (or present a serious impediment to the performance of) critical functions.

14. The FSB proposes that, to provide operational continuity in the two stages of resolution, the following arrangements could be considered:

    - *"Contractual provisions*. Banks should have clearly and comprehensively documented contractual arrangements and service level agreements (SLAs) for both intra-group and third party critical shared services which, to the greatest extent possible, remain valid and enforceable in resolution, provided there is no default in payment obligations.

    - *Management information systems (MIS).* All arrangements and models should be supported by a clear taxonomy of shared services and the maintenance of up-to date mapping of services to entities, businesses and critical functions. MIS should allow for timely reporting on the provision or receipt of critical shared services on a legal entity and line of business basis, including information about ownership of assets and infrastructure; pricing; contractual rights and agreements; and outsourcing arrangements.

    - *Financial resources.* Intra-group providers of critical shared services (including where the services are provided within regulated entities) should have sufficient financial resources to facilitate operational continuity of critical functions in resolution. Where an entity relies on third party critical shared services, the service recipient should have sufficient financial resources to ensure that the third party provider continues to be paid. In all cases, the financial resources should be sufficient to cover both the stabilisation and restructuring phases of resolution.

    - *Robust pricing structures.* Cost and pricing structures for services should, to the extent permitted by tax and legislative requirements, be predictable, transparent and set on an arm's length basis with clear links, where relevant, between the original direct cost of the service and the allocated cost. The cost structure for services should not be directly or indirectly influenced by the financial performance of the service recipient. This arrangement is relevant for the provision of critical shared services through an intra-group service company (to ensure the service company is financially viable on a stand-alone basis) or through a regulated entity (to ensure that the documentation could form the basis of an external contract if the regulated entity is restructured in resolution).

- *Operational resilience and resourcing.* Critical shared services should be operationally resilient and have sufficient capacity (for example, human resources and expertise) to support the restructuring phase following the failure of a group entity or group entities. Banks and authorities should plan for the retention of key employees during the restructuring phase. In any event, critical shared services should not be unduly affected by the failure or resolution of other group entities.

- *Governance.* Critical shared services should have their own governance structure and clearly defined reporting lines. Where services are provided by a division of a regulated entity, for example, this could entail some element of independent management and responsibility at board level. Governance structures should ensure that provision of critical shared services is possible in resolution without relying on senior staff from certain business lines that may be wound down or that may no longer form part of the same group. The governance arrangements relating to critical shared services could be assessed by the firm's internal audit function.

- *Rights of use and access.* Access to operational assets by the critical shared services provider, the serviced entities, business units and authorities should not be disrupted by the failure or resolution of any particular group entity. In some cases, this may require that operational assets essential to the provision of critical shared services are owned or leased by the same legal entity providing those critical shared services (that is, by the regulated entity or by the intra-group service company, depending on the model used). Where this is not the case, contractual provisions to ensure rights of access could be considered. Service recipients should also not be restricted from using shared assets directly where appropriate. Continued access to IT, intellectual property and operational services during the restructuring period should be considered as part of resolution planning."

15. The FSB guidance notes the importance of service level agreements in the provision of shared services. In particular, it notes that:

- "Services received from both third party and intra-group entities should be well documented and have clear parameters against which service provision can be measured.

- The terms of SLA service provision and pricing should not alter solely as a result of the entry into resolution of a party to the contract (or affiliate of a party).

- SLAs should explicitly contemplate that services may be transferred or assigned in resolution. As long as payments and other obligations continue to be met, the service provider should not have a right of termination by reason of any such assignment or transfer.

- SLAs designed to provide service to a "group" should have clauses that, as far as possible, allow for the continued use of such products or receipt of such services by (former) group entities for a reasonable period of time following a divestment resulting from a resolution, in order to support group restructuring.

- SLAs should include explicit provisions that exclude early intervention, resolution and cross-default events as grounds for termination or contractual modification (provided that the service provider continues to be paid)."

16. The FSB notes that any service model (or combination of models) used by a bank will need to support business separability and restructuring, even if the bank's resolution strategy aims to keep the group largely intact. It observes that, even in the execution of an SPE resolution strategy, it cannot be assumed that the structure and business operations of the bank will remain unchanged; restructuring is likely to be necessary to address the problem(s) that caused the bank to enter resolution, and non-material entities might not be preserved. Options for divestment should be contemplated under any resolution strategy, and this should be taken into account in planning for operational continuity. Moreover, the actual resolution will depend on the circumstances of the failure (even if authorities have developed preferred resolution strategies).

17. The FSB notes that, in order to support cross-border cooperation in the execution of a resolution strategy, home authorities should as far as possible provide host authorities with reasonable comfort that in-house or intra-group service providers have sufficient financial resilience and appropriate governance arrangements, and will continue to provide critical shared services that support critical functions in the host jurisdiction. This may be particularly pertinent, for example, where critical shared services are provided to local subsidiaries from a branch in the host jurisdiction.

United Kingdom

18. Since the global financial crisis, the United Kingdom, in conjunction with the European Union, has developed a comprehensive bank resolution framework. It is modelled closely on the principles set out in the Key Attributes.

19. An important element in this framework is the treatment of cross-border coordination. In that regard, the Bank of England (BOE) and its subsidiary Prudential Regulation Authority (PRA) have established supervisory colleges and CMGs in respect of the major UK banks with cross-border operations. So too have the supervisory and resolution authorities in other EU jurisdictions. These supervisory colleges and CMGs provide the forums within which detailed cross-border whole-of-group resolution plans are being developed in respect of the major cross-border banking groups.

20. In October 2015, the BOE PRA issued a Consultation Paper CP38/15 entitled: *Ensuring operational continuity in resolution*.[6] This paper draws on FSB guidance and sets out proposed arrangements for maintaining continuity of critical functions in a bank distress or failure situation.

21. The paper argues that banks need to be structured to facilitate continuity of critical shared services by ensuring their operational arrangements support recovery and resolution plans. Structures that support business separability and restructuring can improve the ability of firms to continue critical functions without significant interruption in stress or resolution. If firms cannot demonstrate that their operational

[6] This paper is accessible at: http://www.bankofengland.co.uk/pra/Documents/publications/cp/2015/cp3815.pdf

structure supports separability and restructuring, the PRA expects firms to make changes to achieve this.

22. The PRA paper notes that critical shared service arrangements need to be capable of being continued or replaced and there should be agreements in place documenting these appropriately. It argues that an inability to provide timely and accurate information relating to critical shared services, as well as poorly designed or inadequate agreements, may present an obstacle to continuity of critical shared services in resolution, particularly if agreements can be terminated on entry into stress or resolution of the firm or other group entities.

23. The paper proposes that critical shared services provided from within the group need to be structured so that upon failure or resolution, no group entities receive preferential access to critical shared services over other entities, as this could result in disruption to service provision to the entity being resolved or other group entities.

24. It notes that critical shared service providers need to be financially and operationally resilient.

25. The PRA states that, in accordance with Rule 3.2 of the Operational Continuity Part of the PRA Rulebook, a critical shared services provider, whether a group provider or a non-group provider, should not be able to change the arrangements of provision as a result of a firm or a member of the group entering into a period of stress or resolution. It is expected that steps to achieve this could include:

- clauses in contracts or agreements for critical shared services provided by group providers and non-group providers that allow for continued use of services, and that contracts or agreements remain valid after the firm or a group member has entered stress or resolution, provided there is no default on payment obligations (this does not apply if the contract ends due to an upcoming maturity date);

- clauses in contracts or agreements that allow for the continued use of such products or receipt of such services, by entities following their disposal by a group for a reasonable period of time in order to support group restructuring; and

- agreements with group providers and non-group providers that are enforceable pre and post-resolution.

26. In discussion with a senior official of the PRA recently, they confirmed to the author that the PRA does not prohibit firms from outsourcing critical services to non-UK service providers. Firms that wish to outsource must meet the requirements in the Outsourcing Part of the PRA Rulebook and for critical services in particular they must meet the Operational Continuity Part. Outsourcing permits the outsourcing of critical or important operational functions provided the outsourcing of such activities does not result in:

- a transfer of responsibility from the PRA-authorised firm to the outsource provider;
- an increase in operational risk;
- an impairment of the quality of the firm's internal control; or

- an alteration to the conditions with which the firm must comply in order to be authorised.

27. The PRA official indicated that the main areas that the operational continuity proposals require are that a regulated firm in scope of the requirements ensures that the critical services provider they use:

    - has arrangements in place that are capable of being continued or replaced in resolution that are well documented;
    - has sufficient financial resources and capability to allow the firm to operate in resolution and the service arrangements are capable of being restructured;
    - upon restructuring or resolution of a group member the recipient firm continues to have access to operational assets supporting the critical services;
    - if in the group, has appropriate governance and management structures in place - including having senior staff capable of running the critical services, who are mainly remunerated by, and work for, the service provider; and
    - if in a group, upon deterioration in the circumstances of another group member the group provider continues to provide critical services in accordance with the agreement governing the critical services.

United States

28. Pursuant to the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act), the US Federal Deposit Insurance Corporation (FDIC), in conjunction with the Board of Governors of the Federal Reserve Bank, has been developing its capability for resolving systemically important financial institutions (SIFIs).

29. The FDIC has announced its intention to implement a SPE strategy for the resolution of Systemically Important Financial Institutions (SIFIs). In resolving a failed or failing SIFI the FDIC seeks to promote market discipline by imposing losses on the shareholders and creditors of the top-tier holding company and removing culpable senior management without imposing cost on taxpayers. This would create a more stable financial system over the longer term. Additionally, the FDIC seeks to preserve financial stability by maintaining the critical services, operations and funding mechanisms conducted throughout the company's operating subsidiaries.

30. A senior official from the FDIC has indicated to the author that the FDIC's approach to critical shared services is broadly similar to that of the UK in that their preference is not to necessarily impose a requirement for in-sourcing of critical functionality in subsidiaries. The FDIC generally requires a bank to demonstrate that it can continue to provide critical banking functions if separated from the parent. Separation of subsidiary from parent is regarded as a distinctly sub-optimal form of resolution; the FDIC's preference is to keep the group intact via a SPE form of resolution, with robust intra-group arrangements for continuity of critical shared services if separation proves to be necessary.

Appendix II

Looking at outsourcing and resolution policy in the context of a strengthened banking system

1. This appendix briefly summarises the measures taken since the global financial crisis to strengthen the New Zealand and Australian banking systems. It notes that the two banking systems are strong relative to many other advanced economy banking systems, and stress testing suggests a strong degree of resilience to severe economic shocks. This does not suggest that the RBNZ should not plan for situations of bank failure. It clearly should. But it does suggest the importance of bearing in mind the strength of the New Zealand and Australian banking systems and the importance of avoiding disproportionately costly resolution and outsourcing policies for very low probability events.

2. Since the global financial crisis, supervisory authorities in many countries have implemented reforms to strengthen individual banks and banking systems. This has been aided by the development of new or enhanced prudential guidelines by the Basel Committee on Banking Supervision (BCBS) and Financial Stability Board (FSB). As noted in section III of the paper, much progress has also been made in the development of bank recovery and resolution policies – mainly led by the FSB.

3. The most important international standard developed by the BCBS since the global financial crisis has been the so-called Basel III package of reforms. These were introduced progressively from June 2011 and have been designed to strengthen banks' capital, liquidity and risk management. The reforms include several elements:

   - A re-focusing of capital on equity and other loss-absorbing capital instruments.
   - Raising of CET1 to a minimum of 4.5% of risk-weighted exposures.
   - Requiring all eligible capital instruments to be capable of loss absorption (either by write-down or conversion to equity) at the point of bank non-viability.
   - Introduction of a capital conservation buffer of 2.5% of risk-weighted exposures.
   - Introduction of a counter-cyclical capital buffer of up to 2.5% of risk-weighted exposures.
   - Strengthening the capital requirements in relation to securitisations, trading book positions and counterparty credit exposures.
   - Introduction of a leverage ratio requirement to ensure a minimum buffer of equity to total assets.
   - A strengthening of market discipline through enhanced disclosures of risk positions.
   - A strengthening of liquidity requirements, including through the establishment of a Liquidity Coverage Ratio and Net Stable Funding Ratio.

4. These initiatives have been accompanied by other measures to strengthen the resilience of financial systems, including the enhanced use of stress testing of individual banks and banking systems as a whole and macroprudential policy instruments. There has also been a renewed emphasis on the importance of bank governance and risk management policy and practice. The BCBS have also focused attention on the need for strengthened supervision of banks, including through a risk-based approach to

regulation and supervision, comprehensive on-site and off-site supervisory arrangements and a robust framework for the early detection and response to emerging banking problems.

5. Both the FSB and BCBS have also focused their attention of the need for a particular strengthening of the regulation and supervision of systemically important banks, with a view to enhancing the capacity to identify and manage risks in these banks. Important developments in this context have included the establishment of a framework for identifying globally systemically important banks (G-SIBs) and domestically systemically important banks (D-SIBs). An international list of G-SIBs has been established and many jurisdictions have identified their own D-SIBs, including Australia. Enhanced capital, risk management and supervisory frameworks have been or are being applied to both G-SIBs and D-SIBs.

6. Although the BCBS standards and policies are not legally binding on countries, they have very significant influence globally and especially with member countries (which includes Australia). Accordingly, most of the BCBS member supervisory authorities have implemented Basel III and other BCBS initiatives in a manner adapted to their respective jurisdictions' particular characteristics. Beyond the BCBS member jurisdictions there has been a wide uptake of BCBS standards.

7. In Australia, APRA has implemented Basel III, modified to suit the characteristics of the Australian financial system. It has also strengthened its risk-based approach to supervision and has introduced enhanced requirements relating to corporate governance and a comprehensive prudential standard on risk management. Banks are subject to comprehensive requirements in relation to ICAAP, liquidity contingency planning and recovery planning. Stress testing is regularly undertaken by APRA, both of individual banks and the banking system as a whole, and some elements of macroprudential regulation have been introduced. Australia has taken measures to strengthen the framework for dealing with bank distress and failure, including establishing deposit insurance (in the form of the Financial Claims Scheme) and enhanced resolution powers, with more in the pipeline.

8. Although New Zealand is not represented on either the BCBS or FSB, and is not bound by the international standards they promulgate, the RBNZ has implemented a number of measures based on or similar to international standards, especially elements of Basel III. Among other matters, the RBNZ has introduced:

- strengthened capital requirements similar to Basel III, including a minimum CET1 ratio requirement of 4.5%, total capital ratio requirement of 8.0% and a capital conservation buffer of 2.5%;
- ICAAP requirements;
- liquidity requirements, including minimum requirements for short-term funding mismatch positions and a core stable funding ratio;
- strengthened corporate governance requirements;
- increased use of stress testing of individual banks and the banking system as a whole; and

- a range of macroprudential measures intended to reduce the risks associated with lending against residential property and to assist in reducing residential property price inflation, particularly in Auckland.

9. The RBNZ has also implemented some initiatives to facilitate the resolution of banks, most notably its outsourcing policy (as set out in BS11), applicable only to large banks, and the Open Bank Resolution (OBR) policy, applicable to locally incorporated banks with retail deposits in excess of $1 billion. Unlike APRA and most advanced economy supervisory authorities, the RBNZ has not implemented recovery planning requirements, which remains a significant gap in its supervisory framework. Moreover – and a point emphasised in section V of the paper – the RBNZ has not undertaken cross-border resolution planning in close coordination with APRA or in a manner that closely involves the New Zealand Treasury and Australian Treasury. The outsourcing and OBR arrangements are merely a subset of resolution planning and are based on a presumption of separation.

10. Since the global financial crisis, the New Zealand banking system has strengthened considerably. For example, the average total capital ratio for all locally incorporated banks has increased from 10.5% in December 2007 to 13.5% in December 2015. The average tier 1 capital ratio has also increased sharply – from 7.6% in December 2007 to 12.1% in December 2015. The four large banks have displayed a strong increase in capital ratios, with the total capital ratios ranging from 12.2% to 13.8% as at December 2015. Non-performing loans continue to remain very low by historical and international benchmarks, being under 1.0% of total loans as at December 2015.

11. The Australian parent banks have displayed similar strength since the global financial crisis. As at December 2015, the major banks in Australia had average CET1 capital ratios of around 10.0% - well above the minimum requirement applied by APRA of 8.0% for D-SIBs. Their total capital ratio averaged around 13.8% as at December 2015. By international standards, the major Australian banks are well capitalised, and that is in the context of very low levels of non-performing loans (being under 0.5% as at December 2015).

12. Stress testing undertaken by APRA and RBNZ suggest that the banking systems of both countries would be resilient to severe economic and financial shocks. For example, in its May 2016 *Financial Stability Report*, the RBNZ noted that in late 2015 the four largest banks in New Zealand participated in a common scenario ICAAP test. This test was a hybrid between an internal test (conducted regularly with each institution choosing their own scenarios) and a regulator-led system-wide stress test (occurring every 2-3 years with common scenarios and assumptions). It was based on a severe economic scenario in which, among other matters, real GDP was assumed to contract by 6% over three years and unemployment to rise to 13%. Dairy incomes were assumed to remain at low levels and residential, commercial and rural property prices were assumed to fall by 40%, with residential property prices in Auckland falling by 55%. Although, inevitably, banks sustained significant losses in the scenario, they did not come close to failing – their CET1 ratios reportedly fell to around 8.0%. Similar stress testing in Australia by APRA has produced broadly similar results, showing the major banks and banking system as a whole to be resilient to severe economic shocks. (Of course, as with any stress testing, the results depend on

assumptions relating to probability of default and loss given default, which may or may not prove to be correct in a real economic downturn.)

13. Overall therefore, the banking systems in New Zealand and Australia, and the four large banks in particular, are currently in a strong position, both historically and by international benchmarks. Their credit ratings reflect this, being among the higher rated banks in the world. They appear to be well placed to survive potentially severe economic shocks. This does not mean that the RBNZ should not be giving attention to how any of the banks would be resolved in a crisis. It is essential that resolution planning for extreme events is undertaken. However, it does suggest that resolution planning should be undertaken in the context of a banking system that is resilient and where bank failure or acute distress remains a very low probability. This reinforces the argument that resolution planning arrangements, including outsourcing, should seek to strike a reasonable balance between enabling resolution to be implemented in a manner that meets resolution objectives while avoiding unnecessary compliance costs and adverse efficiency outcomes.