

Sent by email

04 December 2015

Victoria Learmonth
Prudential Supervision Department
Reserve Bank of New Zealand
PO Box 2498
WELLINGTON 6140

email: victoria.learmonth@rbnz.govt.nz

Dear Victoria

Consultation on review of the outsourcing policy for registered banks

Thank you for the opportunity to submit on your outsourcing proposals. Our responses to your specific questions are included in the attached table as requested. In addition we make the following overarching comments.

We acknowledge and appreciate the underlying intention associated with the outsourcing consultation, however we are concerned that the proposals are attempting to address broader risks than those specifically related to outsourcing. In particular there appears to be a strong focus on risks associated with outsourcing arrangements between banks and their offshore parents, which are not relevant for SBS or other smaller domestic banks. We are also conscious of the attempt to directly link the outsourcing policy to that of the OBR policy. We understand that there should be some linkage between the two, but believe strongly that an outsourcing policy should focus solely on managing material supplier/vendor risks and that any failure resolution or parent separation issues and risks should be dealt with separately.

Further, as outlined within the consultation document outsourcing can provide key market benefits through efficiency and cost reductions, as well as allowing banks to focus on their core business. As a smaller domestically owned bank, outsourcing is a key element to SBS strategy that enables us to access infrastructure and technologies that would otherwise be uneconomical for any small franchise. Any policy that restricts the ability for smaller banks to engage in these arrangements within the realms of normal governance and risk management frameworks would conflict the objective of ensuring an open and competitive market place by forcing out competition and deterring new entrants by making it not viable to operate under a small franchise.

In particular we are concerned that the proposals outlined do not consider the agency relationship model that operates in the NZ market, nor enables these existing relationships to be dealt with practically. The agency model allows smaller banks, like SBS, an economic option to provide core transactional banking services to their customers by accessing these via a larger market participant such as Westpac. This is particularly vital in relation to the NZ payments system where the fixed establishment costs of core infrastructure and on-going running costs remain comparatively uneconomic for smaller participants to participate directly. We submit that it is important that any outsourcing policy specifically recognises these agency relationships and ensures realistic and practical requirements are incorporated that align to the overall risk, likelihood and financial system impact associated with these. We believe that a logical solution would be to specifically exclude any outsourcing arrangements that are with other NZ registered banks whom are regulated by the BS11 policy.

In regard to lowering the BS11 threshold to \$1 billion of retail deposits to align with the OBR policy, SBS submits strongly against this proposal. As a bank that would be directly impacted by this we note that this would significantly impact not only ourselves, but also other smaller banks, by creating an unreasonable compliance burden that is disproportionate to our size, complexity and any overall risk impact in relation to the wider financial system in the event of failure. We do not believe that the consultation document provides sufficient justification for lowering the threshold for smaller non-systemic banks.

We are also concerned that alignment to the OBR threshold would still exclude some market participants by virtue of them operating under a branch structure. Given the costs and administrative overhead associated with the BS11 policy, this would give them an unfair competitive advantage over other banks that are captured. This could also allow incoming market participants to structure their affairs to avoid these requirements.

We appreciate the opportunity to respond to your proposals and welcome further consultation with you in this regard. If you have any queries, or would like to discuss any of the items raised in this submission, please do not hesitate to contact either myself on 03 211 2345 or Tim Loan on 03 211 0710.

Yours sincerely



Sonia Lawrence
Financial Controller

Email: 

cc: Paula Hontalba, Wayne Evans, Tim Loan

Answers to questions within consultation paper: review of the outsourcing policy for registered banks

<p>Q1</p>	<p>Do you agree with the analysis of the problem? Do you agree that the issues identified in paragraph 24 appropriately identify the potential problems with the banks' use of outsourcing?</p>	<p>Whilst we generally agree with the analysis of the problem as outlined, we strongly believe that outsourcing should not be blurred with parental separation and failure resolution policies. These policies should be kept separate in line with international practice.</p> <p>The analysis should also consider the differences between outsourcing to parent (off-shore) verses to independent third parties as these arrangements could potentially operate differently in the event of either supplier or bank failure. As a smaller domestic bank, all of SBS's outsourcing is to independent third parties and SBS does not have any reliance on off-shore parent companies to provide critical bank services.</p> <p>In relation to broader system risk associated with outsourcing we feel that the analysis overlooks the strong motivations of the bank itself to maintain appropriate risk functions and to operate in a way that ensures the best possible outcomes for any outsourcing arrangements even under stress circumstances.</p> <p>We also note specific references to the risk associated with supplier concentration. We submit that reduction of such a risk is a separate broader issue that should be dealt with through regulation of the supplier and not one that should be dealt with through an outsourcing policy that applies at a bank level. We are concerned that in trying to do so this will potentially create a competitive disadvantage for banks, and in particular new entrants or smaller non-systemic banks, whereby they may be limited from using an established industry supplier if it is perceived by the RBNZ that this will mitigate overall system risk.</p> <p>We also note a definitive shift in the policy focus to a bank's continuing ability to operate post supplier failure or parent separation. As noted above we feel that these issues should be dealt with in separate policies rather than in an outsourcing policy.</p> <p>Overall we believe that a key principle of a sound outsourcing policy is recognition of the role outsourcing plays in promoting efficiency of the financial system, through opening up access to external cost savings and expertise that cannot be supported in-house, whilst also ensuring that banks have in place robust risk management practices to manage any risks from outsourcing.</p>
<p>Q2</p>	<p>Without an outsourcing policy how would you propose that a failure is managed?</p>	<p>We submit that any failure should be managed by a separate policy. This should link into the OBR policy and specifically deal with ensuring continuity of bank services in the event of a failure and include a plan to deal with key suppliers and, where applicable, a separation plan from parent entities.</p> <p>The outsourcing policy should remain a separate policy and focus on managing material supplier/vendor risks.</p>

		In line with normal internal risk management practices, all bank policies should be appropriate for the size and risk profile of that particular bank.
Q3	Do you agree that the current outcomes-focus should be retained?	<p>Yes, whilst it is important to provide regulatory certainty, we also believe that this approach is the most pragmatic & appropriate as it enable banks to address the policy within the context of their own governance and risk management frameworks.</p> <p>However we would also encourage the RBNZ to ensure that the policy outcomes consider the differences between banks with outsourcing arrangements with off-shore parents verses those that do not.</p>
Q4	Do you agree that changing the objectives to focus more on resolution is right?	<p>We are reasonably comfortable with this approach given the underlying relationship between OBR and certain risks that may arise from outsourcing. However, we reiterate that any resolution policy should remain separate from any outsourcing policy.</p> <p>We would also like to ensure that there is clarity and pragmatism around what constitutes resolution, in particular the expectations around ability to carry on the 'basic business' of a bank as this could be interpreted very differently across the industry.</p>
Q5	Do you agree that the current outcomes are appropriate? Do you agree that the outcomes should also include a resolution-focused requirement? Please explain.	<p>Yes, we agree that the outcomes outlined in paragraph 49 would be appropriate.</p> <p>We note however that the requirement for a bank to be able to operate as a stand-alone entity in the event of separation from its parent is not applicable to all registered banks in NZ. In addition we would encourage the RBNZ to ensure that these outcomes, and the terms used with them, are well defined to ensure certainty and consistency.</p> <p>In terms of a resolution focused requirement, we do not agree that this should be incorporated as the basis of resolution could vary significantly dependant on the underlying driver.</p>
Q6	Do you agree that the matters identified above are the appropriate matters for inclusion in a separation plan? Are there any matters that have not been identified above, but should be included?	<p>Yes, in principal we agree that the matters identified would be appropriate for inclusion within a separation plan.</p> <p>In line with our previous responses however, we feel that any separation plan should be kept distinct from an outsourcing policy.</p> <p>We also note that separation plans are not relevant for those banks, such as SBS, whom do not receive outsourcing support from a parent or other group entities so any policy requirements should be clear on this.</p>

Q7	<p>Does the proposed definition appropriately define outsourcing? If not, please provide an alternative definition that, in your opinion, better captures what is meant by the term outsourcing.</p>	<p>Whilst we fully support the inclusion of a definition of outsourcing into the policy, we believe that the definition proposed is very broad and needs to be more concise. In particular we are concerned by the use of the word 'activities' as it is not clear what this would capture.</p> <p>We would suggest that the definition proposed be amended to link back to the overall policy objectives around ensuring basic business continuity of the bank and financial system stability. This would help to narrow the interpretation back to a focus on core banking functions and exclude unessential or bespoke functions.</p> <p>In addition we would strongly recommend that a materiality threshold is introduced to ensure that the policy does not capture items that are not core to maintaining the continuity of banking services, or those which are just general procurement. Utilisation of such a threshold will also support the on-going practical workability of the policy by removing immaterial contracts that do not pose any significant risk in the event of failure.</p>
Q8	<p>Are there any other functions that should be exempted from the outsourcing policy, but are not captured in the list above?</p>	<p>We support the use of a whitelist of exclusions from the outsourcing policy however as noted above believe that this should be used in conjunction with an overall materiality threshold.</p> <p>Other functions that we believe should be exempted from the policy are:</p> <ul style="list-style-type: none"> - credit background checks and information services - debt collection - maintenance and support of licensed software - agency and/or brokerage agreements - production of plastic credit/debit cards - cheque printing - marketing services - property management - document management/archiving/destruction - cleaning contracts - cash transportation services - recruitment, contractor and consultancy services <p>We are very conscious that there may be various other non-core functions that we have overlooked and again strongly encourage the use of a materiality threshold to avoid the need to have an extensive and detailed whitelist.</p>
Q9	<p>Do you agree that there are functions that are so integral to carrying on the business of a bank that they should not be outsourced? Do you agree that these examples are appropriate? Are there any other functions or systems that should not be outsourced?</p>	<p>We are comfortable with the proposals that a bank should be able to calculate its own financial position and undertake regulatory reporting using its own data. As a smaller domestic bank, SBS does not outsource these core functions. It would be useful however for the RBNZ to provide definitions or more clarity around what specific terms mean such as 'regulatory reporting'.</p>

		<p>In relation to the proposal around a bank having its own SWIFT gateway, we note that the consultation document states that banks can use independent third parties for this function. SBS, like many of the other smaller domestic banks, has an agency relationship [REDACTED] to undertake transactional banking services. This is a commercial arm's length arrangement and includes [REDACTED] SWIFT gateway. We have assumed that this option would continue to be available under policy proposals however we would appreciate receiving some clarity from the RBNZ around this and also recommend that the policy be made more explicit.</p> <p>If this is not the case, and all banks are required to become direct participants in the payment system with their own SWIFT gateway, this would create significant and disproportionate costs to smaller market participants. We would also question how this will add to the overall soundness of the financial system particularly when under an agency relationship the function is being outsourced to an already regulated New Zealand institution.</p> <p>With this in mind, we therefore submit that the outsourcing policy should specifically exclude any arrangements which are with other NZ registered banks that are subject to the BS11 policy.</p> <p>Further to this, we would like to stress the importance of the agency relationship model in the NZ market. This model allows smaller banks, like SBS, an economic option to provide core transactional banking services to their customers. This is particularly vital in relation to the NZ payments system where the fixed establishment costs of core infrastructure and on-going running costs remain comparatively uneconomic for smaller participants to participate directly.</p> <p>We are also concerned about the practical ability for smaller banks, like ourselves, to comply with the outsourcing policy as proposed in regard to an agency relationship. Whilst there may be an ability to seek some assurance from a supplier of agency services around their own contingency arrangements, it would be extremely difficult to provide evidence of how that function could be brought in house and impractical to have an alternative supplier in place. This could leave agency banks in an untenable position around compliance with BS11. We submit that it is important that any outsourcing policy specifically recognises these agency relationships and ensures realistic and practical requirements are incorporated that align to the overall risk, likelihood and financial system impact associated with failure of either party.</p>
Q10	Do you think an outsourcing arrangement compendium would be useful as a reference record between the Reserve Bank and a bank?	<p>Yes, we agree that an outsourcing arrangement compendium would be useful as a reference record for banks that are required to comply with BS11.</p> <p>We note however that maintenance of the compendium is an on-going obligation. We would encourage detailed guidance on the practical application of this, particularly where contracts are negotiated, approved and executed at different dates, as without this guidance a bank could inadvertently breach their condition of registration requirement around maintaining the compendium.</p>

Q11	Are there any other matters not addressed above that should be included in the compendium?	In line with our previous comments we submit that there should be a materiality threshold that applies to the compendium to ensure the document does not become overly detailed or onerous.
Q12	What are the costs to you of establishing and maintaining an outsourcing arrangement compendium that forms part of your conditions of registration?	<p>We estimate that the cost to maintain a formal compendium in line with conditions of registration would be [REDACTED]. This is based on an expectation of extra time and resource required to actively manage the compendium in accordance with BS11 requirements, including engagement with RBNZ.</p> <p>We estimate that the cost to initially establish the compendium in line with the BS11 requirements would be significant [REDACTED] as this would involve a comprehensive review of current practices and all supplier contracts, and where required renegotiation of these to bring them into compliance with BS11. This will involve both internal time and resource and external legal advisors.</p> <p>We submit that the cost of establishing such a compendium and bringing contracts into line with the specific requirements of BS11 is disproportionate to our size and complexity.</p>
Q13	Do you agree that all contracts for outsourcing arrangements should be required to include the terms outlined in paragraph 81?	<p>Whilst we appreciate guidance on standard terms that should be incorporated into outsourcing contracts, we note that not all terms will be relevant and therefore there should be flexibility or discretion allowed to align to the commercial nature of the contract as well as its overall risk and materiality.</p> <p>We also note that paragraph 81(b) is not relevant to bank's that do not receive outsourcing from a parent.</p>
Q14	Do you agree that option two is the most appropriate option for the assessment of outsourcing arrangements? Please explain.	<p>Yes we agree that option 2 is the most efficient option of the two however we note that this would still involve a significant administrative cost in terms of time and resource from the RBNZ to assess each arrangement.</p> <p>We also question how practical this would be to implement and operate in terms of day to day operations. In particular we are concerned that this approach may hamper the timeliness of contract negotiations, internal sign offs and an ability to do business efficiently. We believe that a more appropriate time for any engagement with the RBNZ on an outsourcing contract would be upfront, before any contract negotiations are commenced. That way guidance can be received on any specific requirements or concerns so these can be addressed or built into any contract negotiations and internal approvals.</p>

Q15	Do you agree that the approach outlined above is an appropriate way to manage the assessment of outsourcing proposals? If not, please explain.	Whilst we agree in principal with the approach outlined, we are concerned about the timeliness of any assessments and urge the RBNZ to commit to a definitive turn-around time. We would also encourage transparency around the assessment process including whether there is an ability to appeal decisions.
Q16	Do you agree that having standardised applications would assist in reducing the time taken to assess outsourcing proposals?	Yes
Q17	How many requests per annum do you expect to file in a business-as-usual state? How many requests do you expect to file at the outset of the policy?	<p>The number of requests filed would be totally dependent on the final policy. As noted in our previous comments the current wording is very broad and ambiguous so the contracts captured under the policy could be extensive.</p> <p>If we were to assume a reasonable materiality threshold and that the policy only captures core banking functions we would estimate up to 5 contracts per annum in a business as usual state.</p>
Q18	Do you think that the threshold for the outsourcing policy should be aligned with the threshold for OBR pre-positioning, given the inter-linkages of the two policies? Would your bank be impacted by an alignment? If so, provide detailed comments.	<p>No we do believe that the outsourcing policy should be aligned to the threshold for OBR. Whilst we understand there are some linkages between the two policies, as previously noted we strongly believe that an outsourcing policy should remain a separate policy with a focus on managing material supplier/vendor risks and any failure resolution issues should be included within a separate policy in line with international practice wherever required. Accordingly lowering the threshold solely to satisfy failure resolution issues is not reasonable.</p> <p>As a bank that would be impacted by this alignment we submit that lowering the threshold of BS11 to retail deposits of \$1 billion would significantly impact both ourselves and other smaller banks by creating an unreasonable compliance burden that is disproportionate to our size, complexity and any overall impact on the wider financial system in the event of failure. We do not believe that the consultation document provides sufficient justification for lowering the threshold for smaller non-systemic banks.</p> <p>We are also concerned that alignment to the OBR threshold would also exclude some market participants by virtue of them operating under a branch structure. Given the costs and administration overhead associated with the BS11 policy, this would give them an unfair competitive advantage.</p>

Q19	Do you agree that 6 months is an appropriate amount of time for banks to provide the Reserve Bank with a plan for how it will come to compliance with the revised outsourcing policy, noting that the form has not yet been finalised?	Without a full understanding of the final policy and its collective impacts, it is hard to assess whether a 6 month timeframe would be appropriate in terms of preparing a plan for compliance. At this stage however, and based on the current proposals, we would estimate that a 12 month timeframe would be more appropriate given this would be a significant change for us and require engagement with multiple external parties.
Q20	Do you agree that 2 years would provide a sufficient timeframe to reach compliance with the policy?	Again, this will depend on the requirements of the final policy released. At this stage we believe that a 2 to 5 year transition to reach compliance would probably be appropriate. This will allow an appropriate transition for existing contracts as they come up for renewal.
Q21	How much do you think transitioning to compliance will cost and how could those costs be reduced by an appropriate transitional path?	<p>As noted above we believe that the initial costs of transitioning could be estimated [REDACTED]. This is because we will need to conduct a comprehensive review of our current supplier arrangements and where applicable make amendments for these to comply with the BS 11 requirements.</p> <p>This estimate assumes that existing contracts will be able to be amended where required during any normal business as usual renewals (essentially using a grandfathering approach). A transition period that accelerates this process is likely to incur additional costs where contracts need to be broken and renegotiated mid-term and also where additional resource is required to fulfil these requirements on top of BAU resource.</p>