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NEW ZEALAND
BusinessROUNDTABLE
PROMOTING POLICIES FOR A BETTER NEW ZEALAND

BY E-MAIL

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Re: Outsourcing Policy
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Comment on the Reserve Bank's Proposed Outsourcing Policy for Systemically Important Banks

This comment on the Reserve Bank's Consultation Paper 'Proposed Outsourcing Policy for Systemically Important Banks' is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.

The Consultation Paper proposes (paragraph 21) to require, as a condition of registration, that "systemically important banks" be capable of being operated on a stand-alone basis. The Paper states (paragraph 20) that the Reserve Bank views stand-alone capability to be "a key part of a bank's ability to carry on its business in a prudent manner". It sees outsourcing as an "important "influence" on stand-alone capability. It invokes section 78(1)(e) of the Reserve Bank of New Zealand Act 1989 (the Act) in support of the proposition that if a registered bank is to carry on business "in a prudent manner" then it needs to separate its business from other businesses and from other interests of its owners.

We have several concerns about the propositions contained in paragraphs 20 and 21. We raise them in the context of section 68 of the Act. Section 68 requires the Reserve Bank to exercise its banking supervision and regulation powers for the purposes of:

(a) promoting the maintenance of a sound and efficient financial system; or

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

Our first major concern is that the proposal that major banks should be made to operate on a stand-alone basis seems bound to impair banking efficiency by forcing them to rely on possibly more costly and less expert in-house resources. If so it violates section 68(a). Our second

major concern is that the proposal might violate section 68(b) by raising the likelihood of significant damage to the financial system as a result of the failure of a registered bank.

Elaborating on our second concern, we note that the likelihood of significant damage depends on the probability of failure and the costs of failure.

One element affecting the probability of failure is moral hazard. A risk here is that the more the Reserve Bank sanctions the notion of systemically important banks, the more it risks creating the impression that some banks are 'too big to fail'. It also seems possible that outsourcing could reduce the probability of failure through diversification and access to greater expertise and capital. A prudent owner of a New Zealand bank might wish to guard against local management failure by ensuring that some operations were not fully under the control of the New Zealand managers. Insofar as the proposal forces all New Zealand banks to rely on in-house resources, it may increase the exposure of the banking system to risks that are geographical in nature.

On the question of the costs of failure, it seems obvious that the key issue in the event that a bank becomes insolvent is likely to be the willingness and capacity of a cornerstone shareholder to underwrite an injection of capital. Any proposal that might weaken the links between a New Zealand bank and an overseas parent bank might make it harder for New Zealand banks to assure depositors and creditors that they can access resources in a crisis. A proposal that weakens the clarity of property rights in relation to the ranking of creditor or depositor claims might also weaken the ability of a New Zealand bank to access additional resources in a crisis. We are concerned here that the proposal sketched out in the appendix to the Consultation Paper does not appear to guard against arbitrary decision-making in respect of private property rights. The probability of failure may be greater the less secure are property rights in the event of failure.

At best we consider the case that the Bank's key proposal is consistent with section 68(b) of the Act is unproven. Even if it were justifiable under section 68(b), the proposal could still fail under section 68 because of its impairment of the efficiency objective (section 68(a)). The Consultation Paper does not address this issue of the trade-off between these objectives. As a result it has not established that the proposal satisfies section 68.

If, notwithstanding our objections above, a serious analysis established that the key proposal would be justifiable under section 68(b), but not under section 68(a), the Reserve Bank would run up against the problem that the legislation does not provide any guidance on what should be done. In such a situation, decisions are formally arbitrary. This is a sign of bad legislation. One legislative solution would be to create a single overriding objective (eg efficiency). A second solution would be to separate the responsibilities for monetary policy (price stability) and for banking regulation so that each responsible authority had a single overriding objective. However, in the light of the current discussions about a single Australasian regulator, there is a need in our view for a more fundamental appraisal of the government's approach to prudential regulation. We are not satisfied that the current approach contains adequate incentives for resisting regulatory capture, particularly by overseas regulators. We are aware of a body of research which finds that banking regulation (including government ownership) has, historically, exacerbated rather than alleviated prudential problems.

In any case, because it is obviously undesirable for the Reserve Bank to make unpredictable trade-offs between the two objectives, we suggest that it should attempt to establish principled rules for making those trade-offs. There is a need for banks and their customers to have some ability to predict future Reserve Bank decisions in these areas.

We are particularly concerned here that Australian banks have invested in New Zealand banks in good faith and that their property rights in managing and controlling New Zealand banks should not be taken without good reason and without due consideration of the issue of compensation. To take property rights arbitrarily without compensation could have a chilling effect on the willingness of these and other overseas banks to invest in New Zealand. It could also be bad for New Zealand's international reputation generally.

This brings us to the more general point that the Consultation Paper does not contain a regulatory analysis of its proposals. It is a Cabinet Manual requirement that regulatory proposals considered by cabinet be accompanied by a Regulatory Impact and Business Compliance Cost Statement. In our view it would not be possible to write a statement justifying the proposal on the basis of the reasoning in the Consultation Paper. It does not show that any alleged problem of private sector failure to act prudently and efficiently exists in reality. Nor does it consider the likely unintended and undesired consequences of its proposed rule. In consequence it contains no assessment of the likely costs and benefits of the proposed course of action. We consider that the proposal in the Consultation Paper should have to overcome a particularly high burden of proof on account of its interference with existing private property rights and its apparently novel and unproven nature in an international context.

In summary, we think the Reserve Bank should not proceed further down this path until it has prepared a competent regulatory analysis of its proposal and subjected it to peer review. The Reserve Bank, like any regulator, faces an obvious conflict of interest when considering matters affecting its own powers and influence. It should not act as judge in its own cause.

Yours faithfully

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