

Discussion

Grant Spencer

In general I agree with Stefan Ingves' proposition that cross-border banking generates negative externalities and makes transnational conflicts of interest more likely. Small host countries such as New Zealand are particularly vulnerable to such conflicts and externalities, particularly in times of crisis. There are a number of different ways to approach this issue, one of which is Stefan's solution involving the creation of a supra-national supervisory agency. However, rather than comment on his specific proposal, I will outline the approach that we are taking in New Zealand in the context of our relationship with Australia.

The four major Australian banks account for around 90 per cent of New Zealand's banking assets, which total about NZ\$300 billion. This is considerably larger than the majors' share in the Australian market. Until the mid 1990s the majors' New Zealand operations were reasonably self-contained. Since then however, technological developments and the drive for cost savings have prompted the banks to centralise many of their core functions in Australia. This ultimately left the New Zealand subsidiaries looking in some respects more like state branches than stand-alone banks.

This trend in the majors' New Zealand operations tended to increase the dependence of the NZ banks on their Australian parents. Combined with differences between the regulatory and legal frameworks in Australia and New Zealand, this raised a number of prudential challenges. For example, if during a financial crisis an Australian bank with a branch in New Zealand became insolvent and was ultimately liquidated, Australian depositors would have a preferential claim over the bank's assets in Australia, even though these may have been partly supporting the New Zealand operation.

Through the late 1990s and into the early part of this decade, the Reserve Bank of New Zealand (RBNZ) became increasingly concerned about the stand-alone viability of the Australian majors' operations in New Zealand. Our policy response included four main elements:

1. requiring the local incorporation of large banks and retail deposit-takers from countries such as Australia that have legislation giving home-country depositors a preferential claim;
2. developing an outsourcing policy for large banks;
3. changing the law to reduce the potential for conflict in the event of financial crises in Australia and/or New Zealand; and
4. developing closer ties between the RBNZ and the Australian Prudential Regulation Authority (APRA).

Local incorporation was achieved at the end of last year after the incorporation of the one major bank which was still operating a branch in New Zealand.

The key element of the outsourcing policy is the requirement that large banks must have the legal and practical ability to control and execute any outsourced functions sufficient to achieve the following, even in the event of stress or failure:

- settling outstanding obligations;
- controlling the core retail New Zealand dollar banking transactions; and
- controlling risk management functions such as data management and financial monitoring.

The RBNZ's approach to this policy has been focused on outcomes. This means that banks do not necessarily have to locate their systems within New Zealand. However, if important functions remain in Australia, the New Zealand subsidiary must still have legal access and control during a crisis. Discussions are ongoing about the arrangements necessary to support such outcomes.

I would also say that we have taken a more flexible approach to the question of the location of wholesale banking systems in New Zealand than we have to the location of retail banking systems. This is because we believe that the benefits of locating wholesale systems offshore are likely to exceed the potential risks. We also take into account the trade-off here between stability and efficiency and so we focus on core capabilities and transactions.

In the legislative arena we have worked with our friends at APRA and the Australian Treasury to bring about changes to the *Reserve Bank of New Zealand Act 1989*, the *Australian Prudential Regulation Authority Act 1998* and the *Australian Banking Act 1959*; all of which occurred late last year. There are two main elements to these legislative changes. The first is that both APRA and the RBNZ are now required to support each other in carrying out their statutory responsibilities relating to financial stability. The second requires the two supervisory authorities to avoid actions likely to have a detrimental effect on the stability of the other country's financial system, where practicable. These changes will not necessarily avoid conflict altogether, but at least we have developed a legal framework whereby each supervisory authority is required to take into account the other country's circumstances during a crisis.

Finally, we are working toward closer trans-Tasman ties in general, with perhaps the best example being the establishment of the Trans-Tasman Council on Banking Supervision in 2005 (members of which are the Australian Treasury, the New Zealand Treasury, the RBNZ, the RBA and APRA). This council meets twice a year, with its initial focus being the legislative changes I mentioned earlier and more recently investigating whether there are protocols and rules that can improve our ability to deal with a crisis. We are also fostering closer links with APRA through staff secondments, increased frequency of meetings, participating in each other's visits to the large banks and our Memorandum of Understanding relating to information sharing and collaboration on supervision issues.

In conclusion, the RBNZ's aim is to recognise the trend towards globalisation of financial services while at the same time giving protection to the core New Zealand banking system in the face of external shocks. The banking system in New Zealand is an important infrastructure asset and we need to protect its effectiveness. Different

solutions to this issue may suit different regions. Thus, Stefan's proposal to set up a new supra-national prudential supervisor for cross-border banks may work well in the European Union where there is a long history of close political ties and a well-established common infrastructure. However, it may not be the optimal solution for us. The key point here is that, in a crisis, small host countries are going to be the most vulnerable. Therefore, small host countries have to take a lead role on this issue and find a solution that will work for their particular circumstances.