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OF COMPETITION AND REGULATION INC.**

**An Analysis of the Reserve Bank  
of New Zealand's Policy on the  
Incorporation of Foreign Banks**

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The views expressed in this paper are those of the authors, and should not be attributed to any of the parties named above.

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## **1. Introduction**

The Reserve Bank of New Zealand (RBNZ) has developed a new policy that will require particular classes of foreign banks operating in New Zealand to incorporate locally rather than operating through a branch structure. This policy will change the institutional structure of New Zealand banking, and thus has the potential to have a material impact on the efficiency and stability of our financial system.

WestpacTrust, New Zealand's largest retail bank with assets of around \$18.5 billion, will be directly affected by this new policy. Westpac Banking Corporation's New Zealand business,<sup>1</sup> including the retail operations of WestpacTrust, is currently conducted through branches of the Australian bank.<sup>2</sup> WestpacTrust is a brand utilised by Westpac Banking Corporation for its retail branches in New Zealand and is not incorporated in New Zealand. All New Zealand assets and liabilities associated with the retail business of WestpacTrust are assets and liabilities of Westpac Banking Corporation of Australia.

The RBNZ's new policy on local incorporation will also affect the New Zealand business of AMP Bank, which is currently conducted through a locally-incorporated entity, and will remove the option for other banks to choose to give up local incorporation in New Zealand if they consider it optimal to do so. We understand that until the announcement of this new RBNZ policy two other Australian banks have been considering moving their New Zealand operations to a branch basis by giving up local incorporation.

In this study we analyse the objectives underlying the Reserve Bank's policy of mandatory local incorporation and provide an assessment of the effectiveness of the policy in meeting these objectives. We review both the legal and regulatory framework within which branches of foreign banks now operate in New Zealand, and we review

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<sup>1</sup> Westpac Banking Corporation's New Zealand operations account for over 15 per cent of total group assets and generate approximately 18 per cent of group profit.

the international literature on the costs, benefits and efficiency tradeoffs associated with a policy of mandatory local incorporation. We consider the consistency of mandatory local incorporation with the Reserve Bank's current approach to the regulation of financial institutions and we show that the governance structure that is imposed on New Zealand banks by mandatory local incorporation is likely to reduce the efficiency of their operations. Finally, we examine a number of approaches that may meet the current concerns of the RBNZ at lower cost than a policy of mandatory local incorporation.

## **2. Reserve Bank Policy on Local Incorporation**

### *2.1 Statement of the New Policy on Local Incorporation*

Historically, foreign banks operating in New Zealand could choose to incorporate locally or to operate as a branch of the parent bank. On 27 September 2000, the RBNZ announced its intention to seek legislation that would require banks in the following categories to establish a locally incorporated subsidiary for their New Zealand operations:

- Systemically important banks – that is, New Zealand branches of foreign banks large enough to materially affect the operation of the financial sector as a whole
- Foreign branches that take a significant level of retail deposits in New Zealand and come from countries with legislation giving country depositors a preferential claim in a winding up (which includes Australia and the US)
- Foreign branches that take a significant level of retail deposits in New Zealand and which, in their home countries fail to publish the full information depositors would need to assess financial soundness.

Banks not falling into one of these categories would continue to be able to choose whether to operate as a branch or a subsidiary.

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<sup>2</sup> Westpac's other New Zealand operations consist of institutional banking and payments system assets.

The policy proposal of the RBNZ has subsequently been clarified in two respects. First, it is proposed to set at \$200 million the “significant level” of retail deposits at which the requirement for local incorporation would be activated. Second, after initially indicating that policy would only apply to banks taking retail deposits, the RBNZ has indicated that wholesale banks with New Zealand liabilities of \$10 billion or more would also be required to incorporate.

## 2.2 Rationale for the Policy

The rationale for the policy proposal set out in the 27 September 2000 RBNZ press release is as follows:

*“The new policy is intended to help the Reserve Bank manage a crisis affecting a systemically important bank. In a bank crisis the Bank can appoint a statutory manager. However, with a branch distinguishing the New Zealand business from other parts of the operation may be difficult. With a locally incorporated company it is clear which assets relate to the New Zealand business. This makes it easier to get a bank up and running quickly, minimizing adverse effects on the financial sector and economy.”*

*“The new policy will also help ensure that retail depositors can get the information they need to assess the risk of dealing with a particular bank, as locally incorporated banks are required to publish accounts and other prudential information on a quarterly basis.”*

*“Also, local incorporation means that legislation in a bank’s home country giving preference to depositors in the country would not apply here in the event of a failure.”*

Carr (2001a: 14) extends the explanation for the policy in three ways. First, he focuses on the inadequacies of branch-based disclosure in a regulatory regime that is focused on public disclosure and market discipline. He states that "...in a world where assets can be moved cross border quickly and at low cost ... the branch balance sheet [is] increasingly meaningless as a guide to assets and liabilities which were likely to exist at a point of failure". Second, he notes that for a branch "the lack of local directors militates against the incentive effects of the full force of legal sanctions" applicable to actions that would be contrary to the interests of New Zealand depositors. Third, Carr indicates that the RBNZ's "... concerns about organizational form were aroused well before our thinking on creditor recapitalisation as a means of resolving a failed bank had been developed".

The information currently posted on the RBNZ website indicates that increasing the barriers to post-disclosure transfers of assets is a key rationale for the policy. The RBNZ claims that:

*"...there are no constraints on the transfer of assets between different branches of the same legal entity. Thus branch assets could have been transferred overseas between the date of the last disclosure statement and the date of failure, even if they clearly relate to the local branch. With a locally incorporated bank, the Companies Act provides some protection from the transfer of assets out of the local bank in the period immediately prior to the failure."*

This rationale for the new policy on local incorporation was stressed during a discussion with RBNZ staff conducted as part of this study.

An independent report (Maier 2001) commissioned by the Reserve Bank provides further information about the rationale for the policy change. In Maier's view "The crux of the debate is not strictly about branch vs subsidiary structures, but more importantly about the operation of international law across branch / subsidiary entities" (2001: 2). He found that:

- (i) Issues relating to the ownership and definition of assets exist with both branch and subsidiary structures, but that “virtually all would be more complicated in the branch scenario”.
- (ii) “At the point of failure, the branch and subsidiary structures do not have an identical impact in terms of the Reserve Bank objectives in regard to capital adequacy. The additional difficulties ...thrown up by the branch model may well prove material. I doubt that additional legal or financial structuring can completely overcome the significance of these difficulties”.
- (iii) The board of the parent bank would have a duty, and Australian law might require, consideration of the interests of the bank as a whole in any failure scenario, with the result that “it is likely to be New Zealand law that is breached”. In contrast a local board of a New Zealand incorporated entity would have “unambiguous duties ...couched firmly within a settled body of New Zealand law”.
- (iv) “...there is no simple way for the average New Zealand depositor to evaluate the net impact of [the] various preference effects” associated with the New Zealand branch of an Australian bank, whereas a local subsidiary “...removes the preference effects...”

### 2.3 Interpretation of the RBNZ’s Rationale for the Local Incorporation Policy

In marked contrast to the usual approach of the RBNZ on major policy issues, there appears to be no full-length paper on branch operations of international banks in New Zealand that provides a careful articulation of the policy goals, the options, and the proposed policy response. In the absence of such a paper:

- (i) The inconsistency in the explanations of the rationale for the policy as it has been set out in the different press releases, speeches and communications of the RBNZ serves to create confusion about the goals of the policy and undermine the market’s confidence that the policy has a clear and justifiable rationale.



- (ii) It is not clear how the policy is related to or consistent with earlier RBNZ policy on branch / subsidiary issues and current policy on financial sector regulation more generally.
- (iii) There is also no publicly available evidence that the RBNZ have considered the international literature on the relative merits of branches and locally incorporated entities.
- (iv) There is no publicly available evidence that the RBNZ has undertaken an analysis of the efficiency of the governance structure that they impose by requiring local incorporation of banks given the operational environment and prudential regime in place in New Zealand.
- (v) There is no publicly available evidence that the RBNZ has undertaken a substantive analysis of the efficiency tradeoffs that are associated with mandatory local incorporation.<sup>3</sup>

The focus of the public statements of the RBNZ on optimal management of an insolvent institution, and the absence of a broader consideration of the efficiency of mandatory local incorporation is the more surprising given the RBNZ's broader mandate for the soundness and efficiency of the New Zealand financial system. The independent review commissioned from Maier (2001) by the RBNZ does not provide the comprehensive analysis of the issues and the tradeoffs that is required to fill this gap.

### **3. Systemic Risk and Financial System Stability**

The Reserve Bank's policy will require foreign branches which fall under the definition of a systemically-important bank to incorporate locally. A systemically important bank is defined as one whose liabilities in New Zealand (net of amounts to related parties) exceed \$10 billion. From this it might appear reasonable to conclude that branch banks pose particular systemic risks to the New Zealand financial system. On closer inspection, however, such a conclusion is difficult to support.

Risk in the banking system flows from the way in which the banking system creates demand liabilities and facilitates payments on the basis of a portfolio of loans and other assets that cannot be liquidated at their face value over a short time frame. Though much of the historical literature has focused on bank runs by retail depositors, bank regulators now recognize that the most critical issue is risk concentrated in wholesale markets and on the large value transfers through the payments system associated with the settlement of wholesale market transactions. Systemic risk flows from the failure of one bank owing large sums to other banks in the wholesale market, and from the potential for other banks to fail as a result of their inability to obtain payments from the failed bank.

Following recognition of the magnitude of the risks associated with the traditional overnight settlement processes operating in New Zealand, and based on the view that “payment system risk can be eliminated by the adoption of real-time clearing and settlement arrangements” (Tait 1992: 201), the RBNZ put substantial effort into the development of a real time gross settlement (RTGS) system. While the claim that payments system risk has been eliminated as a result is clearly untenable, the Reserve Bank’s own work concludes that the introduction of RTGS with liquidity provided by the RBNZ on a fully-secured basis has substantially reduced systemic risk associated with the payments system (White 1998; Hampton 1999). This reduction in risk has been enhanced by the voluntary interbank deposit agreements in New Zealand and Australia aimed at providing mutual support to an individual bank during a liquidity crisis. Risks remain in respect of retail payments that continue to pass through delayed settlement systems, but the volume of these payments is sufficiently small that problems in settlement *per se* are unlikely to threaten systemic stability.

The RBNZ literature on the local incorporation issue fails to explain why, given these improvements to the operation of the payments system, it is considered that branches of

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<sup>3</sup> In our discussions with them, RBNZ staff have indicated that they do not see an efficiency tradeoff associated with the introduction of the policy.

Australian banks pose more systemic risk than locally incorporated subsidiaries of those banks. Moreover, nothing in the RBNZ literature explains why branches of foreign banks are considered to pose a threat to systemic stability in New Zealand when other countries, such as the US, Australia and Canada take a different view. These countries place no upper limit on the scale of the business that may be undertaken by branch banks operating in their jurisdictions so long as those branches do not take retail deposits. If the answer to this puzzle is that the RBNZ's concerns about the operation of branches is driven by the fact that New Zealand's largest retail bank is a branch rather than a locally incorporated entity, then this suggests that, despite the emphasis on systemic importance in RBNZ statements, the policy is actually driven by concerns about depositor protection. In this case, systemic importance is just a measure of the potential scale of the possible loss to depositors in the event of a bank failure: that is, systemic stability may be threatened by large losses to a large number of depositors. The next section addresses the issue of depositor protection and considers whether local incorporation is likely to enhance the position of New Zealand depositors.

#### **4. Failure Scenarios and Protection of Depositors**

Where Australian banks operate retail branches in New Zealand the claims of depositors in the event of the insolvency of a bank may be affected by Australian law and the actions of the Australian Prudential Regulation Authority (APRA) as well as by New Zealand law and the operations of the RBNZ. In this section we provide a brief review of the relevant legal and regulatory issues. *Our analysis suggests that while legislation in Australia does raise some issues that require consideration by the RBNZ, any policy response must be conceptually and operationally consistent with the approach to prudential supervision adopted in New Zealand, specifically the focus of our regime on disclosure and market discipline rather than depositor protection.*

##### **4.1 Depositor Preference Arrangements Under Australian and New Zealand Law**

Division 2 of the Banking Act (Cth) 1959 deals with the protection of depositors. Section 12 of the Act states that "It is the duty of APRA to exercise its powers and

functions under this Division for the protection of the depositors of the several ADI's". Section 13A of the Act deals with the consequences of the inability or failure of an ADI to meet its obligations. Specifically, sub-section 13A(3) states that "If an ADI becomes unable to meet its obligations or suspends payment, *the assets of the ADI in Australia* are to be available to meet that *ADI's deposit liabilities in Australia* in priority to all other liabilities of the ADI". The ordinary interpretation of this provision is that, in the event of the insolvency of the Australian bank, depositors at New Zealand branches of the bank will rank behind Australian depositors in claims against the Australian assets.<sup>4</sup>

The preference for Australian depositors, and the obligations placed upon APRA under the Banking Act are a mechanism for depositor protection that falls short of the more comprehensive protection that would be available under a formal deposit insurance scheme. However, where a formal taxpayer-funded or taxpayer-supported deposit insurance scheme was established, the actions of the APRA would be similar, with obligations to act to minimise the liabilities of the taxpayer in respect of the deposit insurance scheme.

The Westpac Banking Corporation Act 1982 (New Zealand) provides for similar preferential treatment for New Zealand depositors in relation to claims on the New Zealand assets of the foreign bank. Section 23(2) of the Act states that "In the event of the Continuing Bank becoming unable to meet its obligations or suspending payment, the assets of the Continuing Bank in New Zealand shall be available to meet the Continuing Bank's deposit liabilities in New Zealand in priority to all other liabilities of the Continuing Bank". The Continuing Bank refers to the Westpac Banking Corporation. The ordinary interpretation of this provision is that New Zealand depositors will rank ahead of Australian depositors in claims over the New Zealand assets of Westpac Banking Corporation.

In the case of a failure of a locally incorporated bank in New Zealand, the Reserve Bank, acting as the statutory manager, has the power to take control of all of the assets

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<sup>4</sup> The depositor protection provisions in the Banking Act have not been tested in the courts to date.

and liabilities on the bank's balance sheet. In the case of a failed foreign branch, the branch, not being a separate legal entity, has no balance sheet of its own and therefore legally holds no assets. All of the assets of the foreign bank located in New Zealand are ultimately owned by the parent company. The Act deals with this problem by defining the relevant assets in terms of the assets of the Continuing Bank in New Zealand, as opposed to assets owned by the foreign branch. Under section 23(2) the statutory manager would need to identify the assets of the bank in New Zealand. There is no difficulty with physical assets such as branch property and chattels which will fall within the definition of assets in NZ if they are physically located in New Zealand. The difficulty is in respect of financial assets which may be associated with the New Zealand business but whose physical location may be disputed.

Our interpretation of the implications of these statutes and regulatory policies is as follows:

1. APRA's primary responsibility is the protection of Australian depositors. In the event of the insolvency of a bank, the Australian Banking Act gives Australian depositors a first claim over the foreign assets generated by an Australian bank's branches including those generated by its retail operations in New Zealand.
2. New Zealand legislation provides a countervailing preference for New Zealand depositors over the New Zealand assets of the branches of Australian banks.
3. APRA calculates the risk-adjusted capital requirements imposed upon Westpac with a view only to securing deposits in Australia. It views capital associated with the New Zealand branches of Westpac as alienated to secure New Zealand creditors under the New Zealand legislation.

Under these legislative provisions, the issues for the RBNZ in its role as financial regulator appear to be fourfold. First, it is not clear that New Zealand depositors understand the legal status of their claims on Westpac, and if they do not, it is not clear how the regulator should respond. Second, there is the question of whether, in certain failure scenarios, the claims of New Zealand depositors would have more or less

security if they were claims on a locally incorporated subsidiary. Third, there is the question of post-disclosure asset-shifting. Since this can only be a threat to New Zealand depositors when the transfers occur at less than fair value, it is effectively the threat of looting the New Zealand branches of the bank by the Australian directors or management. Third, there is the question of the legal certainty of the jurisdiction in which assets would fall if a bank became insolvent, and the issue of whether local incorporation changes this.

#### 4.2 Depositor Protection and RBNZ Policy on Bank Regulation

Under the RBNZ policy, foreign banks that have retail deposits in excess of \$200 million will be required to incorporate where legislation in the bank's home country gives local depositors or creditors a preferential claim in liquidation over bank assets located in the home country or where there is inadequate disclosure in the home country. Our view is that the proposed policy is illogical and inconsistent with current regulatory policy in New Zealand in three respects.

1. The rationale for the policy in the case of preferential treatment is that it is currently very difficult for New Zealand depositors to assess their likely position in a winding up. The Reserve Bank's proposed policy will not go to rectifying this problem. No retail depositor is able to make a precise assessment of their likely position in the event of the winding up of a bank. Retail depositors undertake a much more general assessment of the safety of their investments, including assessments of sunk investment in brand recognition and major legal issues such as the preference for depositors in Australia.

Consistency with the RBNZ's stated policy on regulation – market discipline rather than protection of depositors – would be provided simply by a requirement that Westpac make the New Zealand public aware that under Australian law they are unsecured creditors of WestpacTrust. The reaction of depositors to information about their true position would provide

Westpac with a tangible basis on which to balance the costs associated with any consumer unease and loss of custom with the costs associated with local incorporation. In other words, with full information, the market mechanism is capable of effectively dealing with the issue of foreign bank organizational form in a more efficient manner than the imposition of restrictive policy, even where there is preferential treatment of home country depositors.

2. Secondly, if depositors are unable to make an assessment about their likely position in the event the foreign bank in whose branch they have placed their deposit is wound up, and the Reserve Bank is concerned with depositor protection, it is not clear why it is appropriate to allow depositors in banks with retail deposits of less than \$200 million go on being unable to such an assessment. In Australia, the US and Canada the prohibition on foreign branches taking retail deposits applies absolutely, regardless of the level of retail deposits and the home country position. Given that the objective of the policy in these countries is to provide protection to all local depositors, a threshold is not justified. In this way, the Reserve Bank policy is internally inconsistent and does not afford equal treatment to New Zealand depositors.
3. The threshold under which New Zealand retail banks will not be forced to locally incorporate is justified by the RBNZ on a number of grounds that appear to go to at least partial recognition of significant costs associated with local incorporation. Among the justifications given by the Reserve Bank for the threshold is that it will allow branch banks to accept retail deposits as an adjunct to their wholesale business (staff deposits, small deposits from corporates etc) without being in technical breach of requirements.<sup>5</sup> It will also allow a bank to explore retail deposit taking on a

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<sup>5</sup> Reserve Bank of New Zealand, Memorandum to the Treasurer on Proposed Changes to Policy on Bank Organisational Form, 27 January 2000, page 2.

small scale without having to incorporate locally.<sup>6</sup> With this justification for the threshold, the Reserve Bank appears to be conceding within the design of its policy that compelling local incorporation is associated with significant costs that may have the impact of reducing the level of retail activity in the New Zealand banking system. It is not clear whether some type of cost benefit analysis has been undertaken by the Reserve Bank in determining the level of the threshold or whether it has been determined arbitrarily. If the Reserve Bank has specific concerns that justify the imposition of a threshold then these concerns should be made explicit.

#### 4.3 The Trade-Off Between Regulation for Solvency and Regulation to Address Insolvency

According to the RBNZ, the overall objective of bank registration and supervision policies in New Zealand is to enhance the soundness and efficiency of the financial system, not to protect depositors or individual banks.<sup>7</sup> This objective highlights a key deficiency in the Reserve Bank's proposed policy, its failure to distinguish between the questions:

- (i) What is the optimal structure for the management of an insolvent institution? and
- (ii) What is the optimal structure for the overall stability and efficiency of the New Zealand financial system?

The focus of the Reserve Bank in the formulation of the policy is most clearly illustrated by Maier (2001: 2), who states explicitly that his

*...frame of reference in almost all cases was what would happen in practice in the very short period of response time surrounding a failure event. In other words, based on present knowledge, and faced with a defined failure of systemic consequence, how would Reserve Bank /*

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<sup>6</sup> Ibid.

<sup>7</sup> Reserve Bank of New Zealand, Memorandum to the Treasurer, 27 January 2000, page 1.



*Statutory Management activities be materially enabled or curtailed in either a branch or subsidiary context?*

Again, in respect of capital adequacy, Maier (2002: 3) notes that his approach was

*“to focus solely on the ability of a New Zealand statutory manager to quickly, efficiently and effectively take control of hard assets (with minimum risk of successful countervailing legal claims) that could be used to reopen a failed bank”.*

These statements indicate that Mr Maier has focused his analysis exclusively on optimal failure management at the expense of analyzing the impact of organizational form on the soundness and efficiency of the financial system.

As discussed in section 3, the potential for losses to depositors of sufficient scale may act to destabilize the banking system. The development of more certain legal parameters governing failure management will not act to eliminate the prospect of depositor losses in the event of bank failure. Therefore, it is critical to ensure that policies targeted at failure management do not have the effect of compromising systemic stability. If it is the case that policies designed to provide for the effective management of an insolvent institution are neutral with respect to the efficiency of the financial system and the likelihood of insolvency, then there is no efficiency tradeoff that need be considered in the implementation of those policies. If, however, policies designed to provide for the effective management of failure either increase the likelihood that a New Zealand bank will become insolvent, or reduce the efficiency of the operations of the New Zealand banks, then the policy development process must include an explicit analysis of the relevant efficiency tradeoffs. Maier (2001: 2) notes the existence of some tradeoff with respect to the Reserve Bank’s proposed policy on local incorporation *“...it is more than arguable that branch structures could prove more useful in avoiding failures, while subsidiary structures could be more useful in managing the failure process”.*

Regulation that effectively promotes the solvency of financial institutions is particularly important in the New Zealand context. New Zealand is a small, open and relatively undiversified economy. New Zealand financial institutions that have a high degree of exposure to the New Zealand economy are more likely to be severely affected by a specific exogenous shock compared to a more diversified economy. It is significant that each of the financial institution failures affecting the New Zealand financial system, including the BNZ (in the 1890s and the 1980s) and the DFC, have involved locally-incorporated institutions with a high exposure to New Zealand economy. A foreign bank branch in New Zealand, being an integral part of the parent bank, derives benefits from being a part of a more diversified portfolio of risk. A local subsidiary is a separate legal entity, operating on the strength of its own balance sheet would find it more difficult to achieve a similar level of diversification.

The converse of this, of course, is that a foreign branch in New Zealand is exposed to out-of-country risks compared to a locally incorporated entity. White (1992:182-3) notes that:

*In the case of overseas applicants, the Bank does not insist on a registered bank being incorporated in New Zealand, ie. it will register a branch of an overseas bank. From the Reserve Bank's stand point, in one respect, this is a preferred ownership structure for an overseas based bank. Where an overseas bank operates in New Zealand as a branch of the global bank, the overseas bank is directly liable for all the obligations incurred by its branch in New Zealand. It is also a structure preferred by some overseas banks, since it enables them to trade in New Zealand on the strength of their global balance sheet, rather than on just the financial resources of the bank in New Zealand. On the other hand, it needs to be recognised that the New Zealand branch of a foreign bank is directly exposed to, and fully shares in, any problems encountered by the bank wherever in the world they may arise. For this reason, when an overseas bank applies to be registered as a branch in New Zealand, the Reserve Bank has regard to the international standing of the overseas bank and to the nature and*

*scope of the supervision of that bank as conducted by the overseas banking supervisor.*

White's view is that while foreign banks do expose New Zealand to some out-of-country risks, this risk is mitigated where those banks are adequately supervised.

A more recent RBNZ study (Hull 2002) considers only the costs and benefits of foreign ownership and does not explicitly address the costs and benefits of local incorporation and branch operations of foreign banks. She does, however, note that in the case of a New Zealand-specific economic shock New Zealand is "unambiguously better off" as a result of having foreign-owned banks (2002: 29).

The US Treasury/Federal Reserve study (1992) that looked specifically at the issue of whether a subsidiary requirement would enhance the safety and soundness of the US banking system. The Review defined safety and soundness as the extent to which depositors and creditors can be assured that a bank is being operated in a manner that does not expose them to undue risk of loss.<sup>8</sup> The argument that a subsidiary requirement would enhance financial stability was rejected by the Review on the basis that "...more appropriate and effective measures are available for the purposes of protecting safety and soundness." Such measures included "...the promotion of adequate supervisory standards worldwide and the right to prohibit access to the US market by banks that are not adequately supervised." Interestingly, the Review found that there are no significant differences between a branch and a locally incorporated subsidiary with respect to compliance with the law.

The study concluded that, given the experience to date the operations of foreign banks can be operated safely under either organizational form: *"Although, there are theoretical advantages and disadvantages with respect to safety and soundness considerations under the two forms of organization, these distinctions are primarily associated with differences in the way the two forms of organization operate and do not*

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<sup>8</sup> Appendix C, page 4.

*support a conclusion that one form is inherently more safe and sound than the other.”*  
[Appendix C, page 12]

Similarly, in relaxing restrictions on foreign bank organizational form in Canada, the Superintendent of Financial Institutions concluded that the safety and soundness of the Canadian financial system would not be compromised under foreign branching.

From a supervisory perspective, foreign bank branches have some advantages. They are less likely to engage in connected lending; they are subject to additional oversight by foreign supervisors on a consolidated basis with the parent under the terms of the Basel Concordat; they are more likely to obtain financial support from the headquarters; and they may be subject to more rigorous accounting disclosure and reporting requirements (Hawkins and Mihaljek 2001: 29).

Many Asian supervisory authorities note that branches have the advantage of being backed by the full strength of their parent institution, including financial resources, supervision and information technology. They also point out that, under the proposed Capital Accord, branches incorporated in less risky countries will be able to obtain cheaper funds because they will be subject to lower capital weights, whereas subsidiaries will be covered by the ratings of their host country (Hawkins and Mihaljek 2001: 30).

Countries that favour subsidiaries stress their ability to better regulate, supervise and “ring-fence” subsidiaries in periods of distress. Branches are more difficult to sell to third parties when problems arise. The countries concerned point out the widespread practice of restricting the operations of branches as a major weakness of branches from a supervisory perspective (Hawkins and Mihaljek 2001: 30).

In case of branch failure, however, foreign creditors would generally have an advantage over domestic creditors. Local subsidiaries of international banks are stand alone entities with their own capital, and are supervised on a consolidated basis by the

parent's supervisory authority only when the subsidiary is part of a holding company or a universal bank. Nonetheless, reputable international banks closely monitor the activities of their subsidiaries so as to preserve the parent's good name and solid standing. (Hawkins and Mihaljek 2001: 29).

#### 4.4 Local Incorporation and Depositor Protection

In what circumstances would local incorporation provide greater protection to depositors in New Zealand? To consider this question it is helpful to frame the range of plausible failure scenarios.

In the event that Westpac fails, but the assets of the New Zealand branches are sufficient to cover New Zealand deposit liabilities, then the Westpac Banking Corporation Act (1982) should ensure that the assets of the New Zealand branches are available to secure New Zealand depositors. Only if local incorporation provided more legal certainty about the ring-fencing of the New Zealand assets would local incorporation provide any advantages to New Zealand depositors. The materiality of the RBNZ's concerns about the legal uncertainty associated with the domicile of assets under the Westpac Banking Corporation Act 1982 is difficult to assess, and the RBNZ has not made public any substantive legal analysis of the issue. Consequently, there is also no publicly available evidence that this uncertainty would be materially reduced by local incorporation.

An alternative scenario is that through depreciation of asset values in New Zealand the New Zealand business of Westpac effectively becomes insolvent but the global bank, while stressed, remains solvent. In this case the subsidiary may be allowed to fail in two circumstances. First, if the financial position of Westpac constrained it from raising new capital it would not be able to bailout its foreign subsidiary. This is because APRA would require that Westpac raise more capital to maintain its capital requirements based on risk-weighted assets of the group, and would not support any transfer of existing capital to the subsidiary. In such a scenario, the New Zealand

subsidiary would be allowed to fail. Second, the foreign bank parent may consider that it is in the interests of group as a whole that the subsidiary be allowed to fail and may therefore utilize its limited liability (the absence of a legal guarantee of the liabilities to New Zealand depositors) to walk away from the subsidiary. That this approach is feasible is demonstrated by the fact that it was the stance taken by Air New Zealand in the insolvency of Ansett. Whether the decision to allow the subsidiary to fail is effectively made by the bank or its home jurisdiction regulator, New Zealand depositors are materially worse off under this scenario. In both cases a branch structure would make it much more difficult for the liabilities of the New Zealand branch not to be paid while Westpac Banking Corporation remained solvent.

In our view, considerable weight should be placed on the benefits that depositors receive from the legal liability of the parent bank for the payment of the deposits of the branches in New Zealand. Operation through a branch may be taken as a signal of commitment to its New Zealand operations by the parent bank given the legal liability it assumes for all aspects of the operations in New Zealand. Local incorporation might, conversely, be advantageous only as a means of limiting liability for the New Zealand operations, and thus provides a signal that the parent bank may consider walking away from any the local subsidiary if it should fail. Even just from the point of view of this signaling mechanism, depositors might rationally prefer to deal with a branch of a foreign bank.

In the event that Westpac becomes insolvent and the assets of the New Zealand branches are also below the value of New Zealand liabilities, then no advantage arises from local incorporation except in respect of its ability to resolve legal uncertainty.

Finally, we consider the possibility that under any of the above scenarios where the assets available to pay New Zealand depositors are insufficient to meet claims, the RBNZ responds by implementing its “haircut” policy (a write-down of the value of claims that allows the bank to re-open). In this situation, local incorporation is, once again, only valuable if it provides any reduction in legal uncertainty. The principle

challenges with the operation of a New Zealand retail bank under statutory management are likely to be operational (given the extent of systems integration for the New Zealand and Australian operations of the Australian banks) and this will not be resolved by local incorporation *per se*.

There is no publicly-available evidence that the RBNZ has undertaken any careful analysis of the likelihood of these different scenarios, or of the tradeoffs between regulation focused on ensuring solvency and regulation focused on management in the event of insolvency. Consequently, it is not clear that the RBNZ has undertaken the analysis required to consider whether the policy of local incorporation has net benefits for New Zealand depositors. Our analysis raises serious doubts that such an analysis would support the RBNZ's new policy on local incorporation.

#### 4.5 Looting

Throughout the RBNZ statements on the problems created by operation in New Zealand through branches there is reference to the greater ease with which it would be possible for a bank on the verge of insolvency to undertake post-disclosure statement asset shifting.<sup>9</sup> We begin by noting first that only if the asset transfers take place at less than fair value would this activity be of concern to New Zealand depositors or regulators, and second that if asset transfers take place at less than fair value this amounts to the looting (as this term is used by Akerlof and Romer 1993) of the local operations of the bank by the parent.

One scenario suggested to us is that on the eve of the failure of a bank, the Australian parliament could pass legislation that would effectively endorse looting of the foreign subsidiaries and branches of the bank in the interests of maximising the assets available to secure Westpac depositors in Australia. This would not, however, change the legality of the looting in those foreign jurisdictions in which the bank operated. Thus

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<sup>9</sup> We delay until section 5 below consideration of the possibility that the potential for looting is reduced by the existence of independent local directors.

even with Australian government endorsement, the directors of the Australian bank would face legal action in New Zealand should they undertake such activities.

While it is possible that in these circumstances the directors could avoid legal action (by not travelling to New Zealand), it is unlikely that they or the bank would be ambivalent about the potential for such action. No bank that wishes to operate outside its home jurisdiction can have as directors or senior managers individuals with outstanding criminal charges against them. In addition, it seems to use most unlikely that the Australian government would condone actions that were illegal in other countries, even on the verge of a crisis in their domestic banking system. We therefore think that the likelihood of any purposive action to loot the branches of a New Zealand bank is remote, and that the focus of the RBNZ on post-disclosure asset-shifting is misplaced.

## **5. Governance: The Benefits and Costs of a Local Board**

Mandatory local incorporation provides for legal separation of the governance structure of the New Zealand operations of Australian banks from the governance structure for the banks as a whole. In this section we consider the RBNZ's rationale for this policy before developing a more general analysis of its efficiency.

### **5.1 The RBNZ's Analysis of the Benefits of a Separate Governance Structure**

In the RBNZ's discussions of its local incorporation policy much emphasis has been placed on the key role of the local board of directors. As Griffin (2001: 12) put it:

*It would be very difficult to achieve almost all of the objectives we are trying to achieve without local incorporation. This is primarily because a branch does not have its own board with responsibility for looking after the interests of the New Zealand operation. We can impose various duties on the bank as a whole and on the bank's directors but whenever those duties conflict with*



*the interests of the bank as a whole the interests of the bank as a whole would take precedence over those of the branch.*

Under New Zealand Corporations Law the local Board has obligations to act in the interests of the local entity and increased disclosure requirements. In addition, banks incorporated in New Zealand are subject to a condition of registration by the RBNZ that the Bank's constitution "...does not allow the bank's directors to act in the interests of a holding company where to do so would conflict with the interests of the bank, to the detriment of creditors (Griffin 1998: 248). The Reserve Bank views such an obligation as having the effect of more closely aligning the interests of the local board with those of the Reserve Bank and more broadly the interests of New Zealand depositors.

The RBNZ places considerable emphasis on the obligations of local directors under the disclosure framework applicable to locally incorporated banks. As Brash (2001: 5) puts it:

*Each director is required to sign and make certain attestations in the disclosure statements including:*

- *Whether the bank is complying with the prudential requirements imposed on it by the Reserve Bank;*
- *Whether the bank has systems in place to adequately monitor and control its banking risks and whether those systems are being properly applied;*
- *Whether the bank's exposure to connected parties is contrary to the interests of the bank; and*
- *Whether the disclosure statement contains all the required disclosures and is not false or misleading.*

*Directors face potentially severe criminal penalties and civil liability where a disclosure statement is held to be false or misleading.*

Complementing the disclosure requirements, banks incorporated in New Zealand are required to have a minimum of two independent directors (who must also be independent of any parent company) and a non-executive chairman. These requirements are intended to increase the board's capacity to scrutinise the performance of the management team. In addition, independent directors provide some assurance that the bank's dealings with its parent or other related parties are not in conflict with the interests of the bank in New Zealand. (Brash 2001: 5)

The published analysis of the RBNZ places great weight on the benefits of a local board but provides no indication that it has considered the substantial costs arising from the imposition of an independent governance structure on the New Zealand business of the Australian banks. Moreover, there is no publicly available evidence that the Reserve Bank has considered the extensive economics literature on governance issues which is directly relevant to an assessment of the costs and benefits of their policy. If the RBNZ is going to claim that governance and accountability issues are material, it must take seriously the economics literature on these issues.

In our view local incorporation will reduce the efficiency of the governance and accountability structures by:

- Increasing the complexity of the principal-agent relationships associated with the governance structure of the bank;
- Requiring the appointment of outside directors who do not have a financial investment in the local entity (though they may own shares in the global entity);
- Imposing a governance structure that is inconsistent with the efficient operational structure of the New Zealand operations of Australian banks.

Any consideration of the benefits derived from a local board must be accompanied by an assessment of the efficiency implications in terms of the potential costs imposed upon the New Zealand operations of Australian banks.

## 5.2 Principal-Agent Relationships: The Separation of Ownership and Control

The Reserve Bank considers it desirable that the local board will be required to act in the best interests of the local entity. The Reserve Bank views such an obligation as more closely aligning the interests of bank directors with the interests of the New Zealand regulator and / or New Zealand creditors. Specifically, it considers that the existence of a New Zealand board may in certain circumstances be helpful in preventing strategic movements of assets specifically designed to disadvantage the New Zealand bank (and hence New Zealand depositors). This is because the New Zealand board would, in the RBNZ's view, be bound by the constitution of the local entity and have fiduciary obligations to the local entity rather than to the Australian bank.

If WestpacTrust NZ Ltd is a wholly owned subsidiary of Westpac Banking Corporation, the local directors will either not own shares in the local institution or will have shares in the local institution for which there is no outside market. In practice they will therefore have much in common with directors of State Owned Enterprises: they will have liability for the accuracy of the attestations that they sign, but they will not have personal wealth directly at stake in the performance of the New Zealand entity. Liability has a significant incentive effects, but it is diluted by the uncertainty associated with the outcomes of legal processes, and the range of viable defenses that they may mount by the director of an insolvent institution. Liability is thus not a substitute for having personal wealth at stake in the performance of the New Zealand entity where the market directly assesses the performance of the local institution separate from the parent bank.

If the New Zealand directors of WestpacTrust NZ Ltd have substantial investments in the shares of Westpac Banking Corporation, then the incentives claimed by the Reserve Bank will be complicated. New Zealand directors with investments in Westpac Banking Corporation will have incentives based on their personal investments to promote the interests of the global banking entity, and these will reinforce the incentives associated with their obligations to the global entity as owner of the local

bank. How these will weight against the potential liability in the even of the failure of the bank is far from clear. What is clear is that the incentives of the local directors may not be materially different from the incentives of the Australian directors who currently provide the attestations required by the RBNZ. We therefore consider Mr Maier's statement that a local board "...precisely identifies responsible individuals and gives them unambiguous duties (with regard to the New Zealand bank)..." to be incorrect.

An important implication of conferring greater control on local management and independent directors is the risk of over-diversification of the local entity relative to that which is optimal. Local management will be driven to a certain extent by the risk associated with (regulatory and owner) assessment of their performance which may lead to sub-optimal outcomes for the bank. It is well established that investors manage risk more effectively than managers manage risk associated with the performance of the activities they undertake for the firm.

The separation of ownership and control under mandatory local incorporation can also have the effect of distorting the financing decisions of the local subsidiary. In practice there is evidence (see Faccio *et al* 2000 and La Porta *et al* 2000) that principal-agent problems may translate into an insistence on the part of the owner that the subsidiary pay higher dividends (retain a lower proportion of earnings) or impose a higher debt/equity ratio to introduce market discipline for the subsidiary. In the presence of substantial regulatory constraints these policies may not be easily implemented, suggesting that high transactions costs may be associated with the owner's optimal response to the governance structure imposed by regulation.

The RBNZ's local incorporation policy has the effect of giving local managers and independent directors greater control of the New Zealand operations at the expense of the beneficial owner of the company (Westpac Banking Corporation). In combination with the requirements for independent directors and attestations on certain matters, the practical impact of local incorporation is therefore to drive a substantial wedge between ownership and control of the New Zealand subsidiary. This will have the effect of

magnifying the principal-agent problems where the interests of a company's management and owners diverge (Fama and Jensen 1983). Any welfare improvements associated with a shift in control to a local board in the event of the insolvency of the parent bank may well be small by comparison with the ongoing welfare losses (including increased systemic risk) associated with the enhancement of the separation of ownership and control across all aspects of the bank's operations.

### 5.3 Principal Agent Relationships #2: Agents with Two Principals

The literature on corporate governance assumes that managers and directors are agents of the shareholders, and that the fundamental problem of corporate governance is the need to align the incentives of these different groups. Where regulations require the creation of a local board that would not otherwise have been established, the governance structure departs from the private optimum and may therefore involve some reduction in efficiency. In the case of the requirements imposed on the local board in New Zealand, however, the distortion to the private model of governance goes much further. The attestations required of directors of banks operating in New Zealand mean that in this capacity at least the directors owe a primary duty to the RBNZ and to the creditors of the bank rather than the owners of the bank. In the absence of substantial operating autonomy from the parent bank, it is unlikely that the RBNZ requirement for a local board is driven by a desire to strengthen oversight of these operational issues. The directors of the bank incorporated in New Zealand are therefore best viewed as "whistle-blowers" injected into the governance structure of the bank by the regulator.<sup>10</sup>

The practical effect of a governance structure of this type is to provide that directors have two principals: the regulator and the shareholder. The requirements of the regulator therefore go well beyond the requirements for legally binding attestations: they impose on the bank a governance structure which is required only in respect of the regulatory regime, but which must be integrated into the governance structure of the bank. In this way the regulatory requirements are much more intrusive than they need

be. Setting aside any efficiency losses associated with the creation of an unnecessary addition to the governance structure, the dual allegiance of these directors is likely to result in a material reduction in the efficiency of decision-making and governance within the organisation.

Governance problems may also arise from attempts by the management to treat local directors as principals who can be “played off” against the owners of the bank. Where local management disagrees with policies set down by the shareholder, they may attempt to enlist the support of the local directors in repudiating these policies. Where these local directors also have a quasi-official through recognition by or reports to the financial sector regulator the scope for these challenges to policy from the head office of the bank may be extended. Ultimately the ability of management to enlist local directors in support of their views is likely to lead to ineffective governance structures and management capture of decision-making.

#### 5.4 The Quality of Internal Controls and Accountability

The RBNZ has claimed that the disclosure requirements have increased the accountability of bank directors and, indirectly, the accountability of various levels of management within the banks (Brash 2001: 5). In claiming that local incorporation provides superior accountability for actions that are consistent with the interests of New Zealand depositors, the RBNZ appear to have in mind three potential weaknesses in the accountability of directors of the Australian bank. First, in circumstances where the Bank was on the verge of insolvency directors of Westpac Banking Corporation would take actions consistent with their fiduciary obligations to shareholders of the Bank even if those were inconsistent with the interests of depositors in one jurisdiction such as New Zealand. Second, if contradictory legal obligations required directors of Westpac Banking Corporation to make decisions that were illegal in one jurisdiction, then they would make decisions that were consistent with Australian law. Third, Australian

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<sup>10</sup> During their discussions with us as part of the research for this project, RBNZ staff used the term “whistleblower” to describe the independent directors.

directors will place little weight on their liability in New Zealand because of their residence in another jurisdiction.

In our view, the accountability benefits of local incorporation are at best minimal. The Board of Directors of Westpac Banking Corporation currently has liability in respect of the Bank's disclosure statement to the RBNZ and the conduct of its business in New Zealand in a manner consistent with RBNZ regulations. The fact that they are resident in Australia is unlikely to diminish the focus of any quality director on the liability that they might face in New Zealand. Westpac Banking Corporation could not be ambivalent about a situation in which its directors faced criminal charges in New Zealand. Moreover, the Australian government is unlikely to resist extradition proceedings against the directors or to support their continuation as directors of the Bank in these circumstances. Consequently, legal accountability of the directors may not be materially improved by local incorporation.

Even if accountability is not improved, the exposure of the local directors to the risk of personal liability may lead to an increase in the quality of internal controls and thus reduce the risk of failure of the bank. The claim from the RBNZ is that "there has been quite a lot of anecdotal evidence that bank directors are now taking their responsibilities more seriously, and there seems to have been a marked increase in the attention given to internal controls" (Brash 2000: 84 – 85).

Directors of locally incorporated banks may respond to the incentives provided by regulation by reallocating resources, but there should be no presumption that this resource reallocation will actually provide for the quality of internal controls to be improved. Exposure to liability will no doubt cause local directors and management to allocate more resources to tasks, systems and reporting requirements that will minimise their personal risk of liability in the event of insolvency. Note, however, that this response will be driven by an interest in minimising personal liability: it is far from clear that this will have any impact on the actual quality of internal controls or on the probability of insolvency.

Assuming that exposure of directors to personal liability will translate into improved internal controls also represents an overly simplistic view of the relationship that would exist in practice between the Australian bank and the New Zealand subsidiary. The attestations required from local directors implicitly assume a full management structure and choice about the operations of the bank, but this choice does not exist in practice.

### 5.5 The (Mis)Alignment of Operations and Governance Structure

The information technology revolution in banking has provided vast scope for specialization of functions and economies of scale in management. The small scale of the New Zealand market makes it highly inefficient to segregate Australian and New Zealand operations in a range of areas. As a result, all of the Australian banks have reduced the range of management and “back-office” functions undertaken in New Zealand introducing common systems in both Australia and New Zealand and transferring management responsibility or those systems to Australia.

We consider the fact that two Australian banks were considering replicating the WestpacTrust model by moving their New Zealand operations to a branch basis to be strong *a priori* evidence that substantial costs can be avoided through operating within a branch structure given the current organization of banking operations in New Zealand. The move to Australia of many functions formerly associated with a New Zealand head office has increased the costs of maintaining a separately incorporated entity in New Zealand, and made independent governance of New Zealand operations impractical and inefficient. The high level of competition in the New Zealand banking market exerts discipline to ensure that these efficiency benefits are passed on to New Zealand consumers.

One interpretation of the requirements for independent governance and management is that the common systems that each bank operates between Australia and New Zealand would at least be segregated so that the New Zealand business could be controlled by



different staff and would create unique records in the system. We understand, however, that not all of the New Zealand-incorporated subsidiaries of the Australian banks operate in this way. If this is true, and operations in New Zealand are fully integrated into systems and management decision structures that are based in and report to Australia, we consider that there must be substantial doubts about the practical ability of the governance structure in New Zealand to exercise the independence from the Australian bank that the RBNZ appears to envisage. Further, the stated aim of the RBNZ to ensure that there is an entity in New Zealand that could be placed in statutory management and operated as a bank under RBNZ direction may well be inconsistent with current levels of integration of New Zealand operations with those of the Australian banks. It is therefore likely that if the RBNZ continues with its current policy trajectory the costs of mandatory local incorporation will be amplified by the costs of meeting minimum requirements for operational separation that may be established by the RBNZ in the future.

In respect of internal risk management, for example, it is difficult to imagine that as a practical matter the New Zealand directors of WestpacTrust NZ Ltd would exercise independent choice over the fundamental models of portfolio and operational risk management. For example, we cannot imagine that the directors of WestpacTrust NZ Ltd could force Westpac to change its global risk management practices, or alternatively could contract with ANZ for the supply of risk management services because they thought that the practices of ANZ were superior to those of Westpac. Equally, we cannot imagine that it would be efficient for WestpacTrust NZ Ltd to develop its own fundamental risk management systems, since the scale of the New Zealand business is too small to support the cost of staffing and managing a unique system. Requiring New Zealand directors to sign attestations in respect of matters that are (on grounds of efficiency) best decided, and as a practical matter necessarily decided, in Sydney or Melbourne will primarily have the effect of reducing the quality of the independent local directors that the banks are able to get to sign the attestations.

## 5.6 Conclusion

Our analysis suggests that there are substantial efficiency losses associated with the imposition of an independent governance structure on the New Zealand operations of the Australian banks, including an increase in the systemic risk in the banking system. These losses are associated with the enforced separation of ownership and control of the subsidiary, the inconsistency of a separate governance structure with the efficient organization of the business of the Australian banks in New Zealand, and the inconsistency of the attestations required of independent directors with the business structure of the Australian banks in New Zealand. By comparison with these efficiency losses, the efficiency gains associated with having attestations from New Zealand-resident directors and from the establishment of fiduciary responsibilities to a distinct New Zealand entity do not appear to be large.

## **6 Implications for Funding and the Use of Capital**

In a world of zero transactions costs banks would be ambivalent about the cost of establishing separate or segregated systems for subsidiaries, and the costs of alternative vehicles for raising capital and debt. Transactions costs are, however, not zero. The costs of arranging separate lines of credit, of managing systems in a way that provides for separation of the locally incorporated entity, and of meeting the regulatory and compliance costs of a separate entity are all material additions to the costs of banks when local incorporation is imposed.

The United States Department of the Treasury and the Board of Governors of the Federal Reserve (1992) conducted a study on “whether foreign banks should be required to conduct banking operations in the United States through subsidiaries rather than branches.” In unreservedly rejecting the imposition of a subsidiary requirement on foreign bank operations conducted in the US, the Review concluded that:

*“A subsidiary requirement...would impose substantial economic and financial costs on the US operations of foreign banks. In fact, a branch of a*

*foreign bank is able to operate more efficiently than a separate subsidiary of a foreign bank due to a number of factors:*

- 1) the ability to deploy capital flexibility;*
- 2) a lower cost of funding;*
- 3) the ability to compete based on access to the worldwide capital base of its parent;*
- 4) ability to engage in transactions with the home office without significant operational restrictions; and*
- 5) lower transaction costs.”*

In analyzing the likely effect of the policy on efficiency, the Review found that foreign bank organizational form has important implications for both the amount and distribution of the bank’s capital and the bank’s management of liquidity and funding. The organizational form imposed can affect the efficiency with which the capital of the banking organization is used. With a branch form capital can be easily be allocated between the parent and the branch in response to changing growth opportunities. A locally incorporated subsidiary is required to hold a certain amount of capital against its risk-weighted assets, therefore reducing the flexibility of capital deployment.

The US Treasury study found that a requirement to operate through a locally-incorporated subsidiary may result in a higher overall capital requirement for the foreign banking organization. The host country may require the subsidiary to hold additional capital if the subsidiary is unable to build up a fully diversified portfolio of risk. In addition, the home supervisor could also exclude from consolidated capital any portion of the subsidiary’s capital that is not subordinated to the depositors and general creditors of the parent bank.<sup>11</sup>

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<sup>11</sup> We note that in the case of Westpac’s branches in New Zealand the Westpac Banking Corporation Act 1982 means that APRA currently treats capital associated with the New Zealand branches as subordinated to the claims of New Zealand creditors, so local incorporation may not affect thus aspect of the use and allocation of capital.

The US Treasury study also found that a subsidiary form is likely to adversely impact on the cost of wholesale funding, the availability of inter-bank credit lines, and flexibility in the management of liquidity. Any other activities of the foreign bank that rely on leveraging off the parent banks balance sheet will be potentially adversely affected by a subsidiary requirement. A branch's access to funding in wholesale funding markets and to interbank credit is virtually the same as its parent because the branch shares the balance sheet of the parent. A subsidiary, as a separate entity from its parent, has to operate in the market on its own strength of its own balance sheet which will necessarily be smaller and less diversified than that of the parent bank. This will diminish a subsidiary's access to wholesale funding sources and interbank credit or alternatively increase the cost of access to such funds. The parent has the option of formally guaranteeing the obligations of the subsidiary but would usually need to back the guarantee with higher capital requirements in its home country and may have an impact on its own funding.

The imposition of a subsidiary structure also interferes with the global bank's optimal approach to liquidity and funding flexibility. It is common for a multinational bank to pursue a centralised approach to liquidity management across the global operations of the group. A centralized approach facilitates a more efficient organization of bank funds, relative to undertaking separate management for each branch and subsidiary. Under a subsidiary arrangement, a subsidiary must establish its own liquidity management guidelines and manage its own liquidity needs. This may result in an increase in funding costs and reduces the flexibility available to the parent bank to manage liquidity.

In addition, our analysis of the governance structure imposed by mandatory local incorporation is that it provides a tangible basis for divergence between the operating costs of branches and subsidiaries. Where the governance structure imposed on the subsidiary is inefficient, either because it provides for a sub-optimal separation of ownership from control or because of its lack of alignment with the optimal allocation of functions between Australian and New Zealand offices, then higher funding costs

will apply to subsidiary operations. This will be true whether the subsidiary independently obtains funding through equity or debt markets, or whether the subsidiary obtains the funding through its parent. For example, if parent bank guarantees of the debt of a New Zealand subsidiary are recognised by the market as being less efficient than a branch structure this will have implications for the cost of the debt raised by the parent and possibly also for the capital requirements imposed by the regulator of the parent. Any increase in capital requirements imposed by the regulator on this basis would be additional to any funds required because of the change in the priority status of New Zealand depositors resulting from the global bank guaranteeing the retail deposit liabilities in New Zealand.

## **7 International Experience**

This section documents the policies of major countries on foreign bank organizational form. We conclude that Reserve Bank's policy marks a significant departure from the recent international developments in this area. We then look at some lessons from the experience of BCCI and the results of a study conducted by the Bank for International Settlements that warns against the adoption of banking regulation that focuses on multinational bank failure management.

### **7.1 Policy on Foreign Bank Organisational Form in Other Countries**

All of Australia, Canada, the United States, and the EU allow foreign banks to freely choose between branching and local incorporation. The international precedent extends further than these countries: a survey conducted by the Institute of International Bankers in September 1995 found that of the forty countries that responded, only two prohibited the direct branching of foreign banks, Canada and Mexico. Canada has since relaxed its policy and allows foreign branching. Further, the trend in recent years has been towards a relaxation of restrictions on foreign bank organizational form in the recognition of the benefits it presents to the multinational bank and more widely to the local financial sector. At the same time, each of these countries have recognized the

need to protect local depositors and have in some cases prohibited foreign branches from taking retail deposits or alternatively have compelled the foreign branch to participate in a local deposit insurance scheme. The approach of international financial regulators demonstrates that the key issue considered in developing regulations on foreign bank organizational form has been the assurance of depositor protection. Implicit in this focus is the recognition that foreign branches do not pose any particular or unique threat to systemic stability, as claimed by the Reserve Bank.

*Australia:* Foreign branching by banks into Australia was prohibited until 1992 when the Federal Government decided to relax the restriction on foreign bank organizational form. Up until this time, foreign bank entrants were compelled to incorporate locally. The local foreign bank subsidiary was required to meet the same requirements of domestic banks including being subject to capital requirements, and the Reserve Bank of Australia had the power to take control of its balance sheet in the event of insolvency.

As a part of its decision in February 1992 to permit foreign banks to establish branch operations in Australia, the Government determined that “because of the difficulties in ensuring the same degree of protection for depositors with branches as for those with locally incorporated banks, branches would be required to confine their deposit-taking activities to wholesale markets”.<sup>12</sup> A foreign branch is not permitted to accept initial deposits (and other funds) from other sources (individuals and non-corporate institutions) which are less than \$250,000. Retail deposit taking by foreign banks is confined to locally incorporated banking subsidiaries.

APRA’s objection to foreign branches accepting retail deposits related to its ability to take control of the assets of an insolvent foreign branch in the face of potential challenges to the proper jurisdiction of the bank’s assets between the home and host countries. The potential for such challenges has the effect of making the actual level of

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<sup>12</sup> Australian Prudential Regulatory Authority, Application for a Banking Authority Foreign Bank Branches, Prudential Statement J2.

depositor protection uncertain despite Australian depositor preference under the Banking Act. As a result, APRA decided that it was not able to provide the same level of protection to foreign branch depositors as it could in the case of a locally incorporated entity. Given its obligations under the Banking Act to protect Australian depositors, APRA decided to restrict the deposit-taking activities of foreign branches.

**Canada:** Until 1999 foreign banks wishing to operate in Canada were compelled to incorporate locally. In 1999 the Canadian government decided to relax the restriction on foreign bank organizational form following recommendations from the Task Force on the Future of the Canadian Financial Services Sector, the House of Commons Standing Committee on Finance and the Senate Standing Committee on Banking, Trade and Commerce. Two types of foreign branches are permitted – full-service branches and lending branches. Both branch forms are prohibited from accepting retail deposits, defined as deposits of less than C\$150,000. Lending branches are in addition not permitted to accept wholesale deposits, except borrowings from other financial institutions, and are subject to lower regulatory requirements reflecting the fact that there are no depositor funds at risk.

In the case of insolvency of a foreign bank branch in Canada, the separate entity doctrine applies where the branch is liquidated as if it were a separate legal entity. All assets of the foreign bank in Canada, and not just the assets of the branch are available to meet the claims of Canadian creditors.

The House of Commons Standing Committee on Finance and the Standing Senate Committee on Banking Trade and Commerce recommended that the government allow foreign banks to establish branches in the Canadian financial sector, noting that Canada was one of the few developed countries that does not permit foreign branching. The Senate Committee found that capital and corporate governance requirements imposed upon foreign bank subsidiaries had deterred foreign bank entry into the Canadian economy. They identified several benefits associated with branching including “greater operational flexibility, increased lending capacity (basing loan size limits on the parent

bank's capital), and reduced corporate governance requirements." Branching was found to be more cost-effective for new entrants as compared to the subsidiary form, thereby encouraging foreign entry.

The Senate Committee supported a restriction on foreign branches taking retail deposits stating that, there should be "complete protection for the small unsophisticated depositor; there should be no possibility that a retail depositor would ever have to resort to a foreign court if he/she ran into problems with a foreign-owned deposit taking institution." The government noted that the foreign branching rules were developed to increase foreign competition in the banking sector without compromising Canada's high standards of depositor protection.

The Taskforce, in recommending foreign branches be permitted, made it clear that their key concern with organizational form was with depositor protection stating in their report that where a branch does not engage in retail deposit-taking activities, it should be subject to the lightest possible regulation.

**EU:** The Second Banking Directive governs foreign branching between Member States of the EU. Under the Directive, a single EU banking passport applies where a bank incorporated in an EU Member State automatically has permission to conduct banking activities in other Member States through branch or subsidiary form. The foreign branch or subsidiary is authorized to accept deposits in the host member country on the basis of its home country authorization.

The issue of depositor protection is addressed by compelling participation in the home country's deposit guarantee scheme. . This is not the case, however, in the US where despite the existence of a deposit insurance scheme, foreign branches are not eligible to participate in the deposit insurance scheme and are not permitted to accept retail deposits.



**United States:** Foreign bank branches are permitted to accept deposits of any size from foreigners but may only accept deposits in excess of US\$100,000 (wholesale deposits) from US residents. Foreign branches are not eligible to participate in the federal deposit insurance scheme. US branches of foreign banks are required to give asset pledges, a form of minimum capital requirement. Federally licensed branches are required to maintain a capital equivalency deposit in a Federal Reserve member bank in the amount of 5% of the branch's third party liabilities.

### 7.2 Lessons from the Failure of BCCI

The development of arrangements to deal with the financial difficulty and insolvency of multinational banks has been given increasing attention in recent years. The failure of the Bank of Credit and Commerce International S.A. (BCCI) in 1991 highlighted the complexities and uncertainties associated with the failure of a bank having multiple subsidiaries and branches across many foreign countries. Despite the increasing attention, there is no common international approach to the resolution of failed multinational banks.

A study group of the Bank for International Settlements released a study in December 1992 which draws on the BCCI experience to highlight the complex issues surrounding multinational bank failure. The objective of the study was not to produce specific policy recommendations but to identify some important implications for banking supervisors when addressing this issue.

A common theme in the results of the study is that supervisory policies should not necessarily follow liquidation regimes. The study group highlights the inherent danger associated with the development of supervisory policy that focuses on insolvency rather than the efficiency of the financial sector.

*“In some circumstances, gearing supervisory policies rigidly to liquidation regimes could lead supervisors to adopt policies that are incompatible with generally appropriate banking policies, particularly for*

*healthy banks. This could result in an inefficient allocation of capital on a branch-by-branch basis, which would be uneconomic for the industry as a whole, or complicate the task of supervising multinational banks on a consolidated basis.” [page 6]*

The study group emphasizes the complex nature of effectively developing supervisory policies in anticipation of multinational bank failure scenarios. Such policies, in addition to causing inefficiency and harming the operations of otherwise healthy foreign banks, may not actually achieve the desired outcomes sought by the regulator.

*“In essence it is extraordinarily difficult for supervisors – and for banks – to identify and manage all the potential risks posed by the intricacies of laws which might be relevant in the failure of a multinational bank. Thus, pursuing policies based on the expectation of certain outcomes in a liquidation may not be appropriate.” [page 6]*

The study points out the fact that determining the location of assets and capital of a bank operating across multiple international jurisdictions is a very complex legal issue. There is no single overarching policy solution to resolve the uncertainties associated with the claims on the assets of a bank across multiple jurisdictions that each have a unique set of laws governing bank insolvency. Local incorporation is perhaps an overly simplistic approach to an intricate and uncertain legal problem.

There are many ways in which a host regulator may attempt to exert increased control over a foreign bank branch due to insolvency concerns. The regulator may seek to limit the flow of assets between the parent and the branch (and between branches) or ring-fence the branches assets in some other way, for example by compelling local incorporation. In examining the alternative forms of supervisory ring-fencing, the study group warns against the imposition of “overly protective measures” which could contribute to bringing about the actual insolvency of the branch.

Bank insolvency is commonly the result of fraud of bank insiders and can result in bank assets being transferred between jurisdictions and effectively concealed from the reach of regulators. The increasing incidence of insider fraud in bank failure highlights the fundamental importance of effective cross-border banking supervision. The study group stresses the need for regulators to ensure that foreign banks within their jurisdiction are properly supervised on a consolidated basis consistent with the principles set out by the Basle Committee on Banking Supervision. The study identifies adherence to the Basle Minimum Standards as the principal factor in managing the presence of a foreign bank.

*‘The complexities and uncertainties that can result from the liquidation of a multinational bank’s operations confirm that effective consolidated supervision performed by home-country supervisors remains paramount in protecting depositors and other creditors. Further, these complexities and uncertainties reinforce the need for host-country supervisors to be satisfied that banks seeking to enter their markets are supervised by home-country authorities that perform consolidated supervision, consistent with the Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments.’* [page 7]

The implications of the BIS study for banking regulators are clear. Designing bank supervisory and registration policies with a view to the management of multinational bank failure is inappropriate, is likely to be ineffective, and can have adverse impacts on foreign bank efficiency. The policy proposed by the RBNZ seeks to implement supervisory policy which is primarily motivated by liquidation regimes and multinational bank failure scenarios. The policy is therefore contrary to the study group’s approach. Rather the focus of banking regulators should be on compliance with the Basle Committee Minimum Standards ensuring effective supervision of foreign bank activities on a consolidated basis and increased cooperation among bank regulators.

The limited international developments in this area to date have focused on initiatives to achieve cooperation among banking regulators in the light of their differing legal systems. Although the formation of a global international convention on dealing with the insolvency of a multinational bank is not likely in the short term, cooperation is possible on a more limited scale between groups of countries. An example is the European Convention on Insolvency Procedures which was adopted in Europe in 1995. The development of a formal agreement between Australia and New Zealand is likely to be the most effective way of ensuring that the resolution of a failed multinational bank takes place in an efficient and organized fashion in the interests of systemic stability and Australian and New Zealand depositors.

## **8 Alternatives to local incorporation**

Westpac has already put forward some alternatives to local incorporation, including a test to assist in determining which assets fall under the jurisdiction of the New Zealand statutory manager (see memo from WestpacTrust to RBNZ dated 26 July 2001). Westpac proposed that a purposive test would resolve ambiguity where an asset would be treated as being an asset in New Zealand if and only if a person with authority to act for Westpac in New Zealand but not elsewhere would have effective control of the asset, and would be able to realize it for the benefit of creditors in New Zealand. We consider the purposive approach to be flawed if the objective is to achieve a quick resolution of the bank's affairs. The test of effective control is difficult to apply in practice and would be likely to attract extensive litigation from the parent/APRA. Another alternative to the purposive test is to specify in legislation exactly which assets will be taken to be assets in NZ. The difficulty with this approach is that financial products are constantly changing and evolving, making precise definition a problem. Again, this approach is likely to attract litigation from the parent/APRA.

In this section we consider a number of alternatives to local incorporation, assessing both their impact on efficiency and their ability to meet the concerns of the RBNZ. We have identified five options for consideration:

- Market-based approach relying on disclosure;
- Branch asset requirements;
- Contractual alteration of depositor preference arrangements;
- Establishment of a formal deposit insurance regime; and
- Establishment of a trust in which the New Zealand assets of WestpacTrust would be held.

We consider each of these alternatives in turn.

### 8.1 Market-based approach: disclosure

The RBNZ's policy on local incorporation is logically inconsistent with its current approach to the regulation of financial institutions. This is because the RBNZ's current regulatory policy is focused on disclosure on depositor monitoring rather than on active regulatory direction of institutional conduct. The need for a policy of local incorporation rests at least in part on the suggestion that depositors may not be aware of, or may not be able to assess the risk associated with, a branch of a foreign bank as opposed to a locally incorporated subsidiary.

A policy alternative that is internally consistent with the Reserve Bank's regulatory framework, is to allow an informed market determine the optimal foreign bank organizational form. Under this proposal, the Reserve Bank would compel Westpac Banking Corporation to inform New Zealand depositors of the legal implications of their status as depositors at a branch of an Australian bank. Depositors would then be in a position to make a more informed decision whether to deposit their funds with WestpacTrust or a locally incorporated financial institution. Market forces would then dictate whether it is optimal for Westpac to locally incorporate in New Zealand.

It could be argued that such an announcement may have the potential to destabilize the banking system and therefore create the very problem that the Reserve Bank is seeking to avoid. However, the same argument could be made more generally in reference to the Reserve Bank's entire regulatory approach that relies on the maximization of

information flows to market participants, in preference to a more interventionist approach. Moreover, if we accept that the use of market information is an appropriate approach to prudential regulation, then it would be consistent to accept that the market is already aware of Westpac's branch status (if for no other reason than the development of the RBNZA's local incorporation policy). Disclosure is therefore likely to be a much less intrusive option than forcing local incorporation, is consistent with the current policy approach of the Reserve Bank, and would eliminate the current inefficiency driven information asymmetry facing New Zealand depositors.

### 8.2 Branch asset requirements

One of the main arguments put forward by the RBNZ for local incorporation is that it ring-fences the assets of the branch and makes it easier for a statutory manager to deal with the foreign bank. The Reserve Bank has tended to focus on the current difficulties associated with applying the Bank Creditor Recapitalisation (BCR) approach to a foreign branch that has no balance sheet of its own. However, other regulatory authorities have preferred alternative approaches.

A study undertaken by the US Department of Treasury and the Board of Governors of the Federal Reserve (1992) examining the merits of a subsidiary reached the conclusion that compelling local incorporation is an inefficient approach to dealing with the financial difficulties of foreign bank branches. They found that alternative measures that can be applied on a case by case basis, for example, asset maintenance requirements and restrictions on transactions between a branch and its foreign parent (and other branches), that effectively ring-fence the activities of a foreign branch without imposing "the unnecessary costs and inefficiencies associated with a broader subsidiary requirement".<sup>13</sup>

US supervisory authorities have the power to impose asset maintenance requirements upon a branch of a foreign bank that is experiencing financial weakness. Asset

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<sup>13</sup> Page 3.

maintenance restrictions were originally developed as a method of ensuring that, in the event of a liquidation, sufficient assets would be available to effect repayment to depositors and liability holders of the US branch.<sup>14</sup> Asset maintenance involves the foreign branch maintaining a prescribed level of eligible assets sufficient to cover a specified percentage of the branch's third party liabilities.<sup>15</sup> In this way, a branch under asset maintenance possesses some of the characteristics of a locally incorporated subsidiary. Branches are required to maintain specific records and periodically report asset maintenance compliance to the regulator. The benefit of asset maintenance is that it is applied only on a case-by-case basis, and does not affect the operations of healthy foreign banks.

Other methods available to US regulators that can be applied on a case by case basis to a foreign branch include: asset pledge requirements, increased capital equivalency deposits, restrictions on transactions with related parties, funding limitations, growth limitations, and voluntary or involuntary termination of the branch.<sup>16</sup>

In addition to having a variety of mechanisms to deal with the financial difficulties of solvent foreign branches, the US law is equally able to deal with the actual insolvency of a foreign branch. The US regulator is authorized to appoint a receiver where a branch is critically undercapitalized or has become insolvent. In the case that the branch is insolvent, the single-entity doctrine is applied where the branch is treated as a separately incorporated legal entity the purposes of the liquidation. The receiver has the power to take possession of not only all of the assets of the foreign branch but any additional assets of the foreign bank located in the US. There is a preference for the claims of US depositors and other creditors that have arisen from transactions with the foreign branch and the liquidator of the foreign bank is prohibited from paying any claims that would not represent an enforceable legal obligation against the branch if it were a locally incorporated subsidiary. US depositors benefit in that the entire assets of

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<sup>14</sup> Asset maintenance paper, Section 5020.1, page 1.

<sup>15</sup> Board of Governors of the Federal Reserve, Examination Manual for US Branches and Agencies of Foreign Banking Organisations, September 1997, Section 5020.1, page 1.

<sup>16</sup> Ibid, Section 2040.1, page 2.

the foreign bank located in the US are available to meet their claims and there are controls on the payout of claims that would not be considered arms length under a subsidiary form.

On the issue of foreign branch insolvency, the US study concluded that, the event of an insolvency of a foreign branch in the US, US depositors would be treated in much the same manner as depositor of a locally incorporated entity. In both cases, US depositors have claims on the assets under the jurisdiction of the US liquidator. A creditor of a branch, however, would potentially have access to the assets of the foreign parent in other jurisdictions outside the US. Depositors in a locally incorporated entity would not have such a claim, in the absence of a legal or factual basis to pierce the corporate veil.<sup>17</sup> This access to the worldwide assets of the multinational bank was recognized as a crucial factor against imposing local incorporation in the report of the Superintendents Advisory Committee on Transnational Banking Institutions.<sup>18</sup>

The US experience demonstrates that there are alternative ways of dealing with the management of financial difficulties experienced by solvent foreign branches on a case-by-case basis that should be fully considered by the Reserve Bank as viable and more efficient alternatives to imposing local incorporation. In relation to managing the actual insolvency of a foreign branch, the US study not only concluded that US depositors would not be worse off as compared to depositors in a locally incorporated subsidiary, but that access to the worldwide asset base of the parent favoured branch depositors.

### 8.3 Alter depositor preference arrangements

To raise the status of WestpacTrust depositors to be equivalent to that of Australian depositors, Westpac Banking Corporation could enter into private contracts with New Zealand depositors conferring claims on assets of the Australian bank *pari passu* with

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<sup>17</sup> Appendix E, page 1.

<sup>18</sup> Subsidiary Requirements Study, App E page 5.



Australian depositors. This would relieve the concerns of the RBNZ with respect to the depositor preference arrangements in the Australian Banking Act.

However, there are issues regarding the enforceability of such a contract. The Banking Act 1959 provides that Australian depositors have preference in their claims on the Australian assets of the bank. The private contracts made by Westpac would directly conflict with s 13A(3) of the Banking Act. In the event of such a conflict, the provisions of the Act would prevail. Therefore, despite the existence of the contracts, a liquidator would be obliged to meet the claims of Australian depositors in preference to New Zealand depositors. Westpac's contractual promise to New Zealand depositors would be unenforceable. In order for New Zealand depositors to be ranked *pari passu* with Australian depositors, s 13A(3) of the Banking Act would need to be repealed.

The next best solution from the perspective of New Zealand depositors would be to provide them with preference over the remaining assets of the Australian bank and any foreign assets after the claims of Australian depositors have been met. Such a contract between Westpac and its New Zealand depositors is likely to be enforceable, but presents problems of its own. Firstly, there is no guarantee that there will be sufficient assets remaining to meet the claims of New Zealand depositors. Secondly, this type of arrangement would act to subordinate the claims of other bank creditors, for example interbank and wholesale customers. The likely effect would be that Westpac would face a higher cost of funding from these parties.

#### 8.4 Deposit insurance scheme

An alternative to local incorporation that would relieve the need to deal with depositor preference in the home country is the establishment of a local deposit insurance scheme. Such a scheme would act to secure the funds of depositors in foreign branches. Both domestic and foreign banks would be required to contribute to the local deposit insurance scheme, and in the event of the failure of the foreign bank, local depositors would be secured.

This alternative is mentioned for completeness rather than as a serious policy alternative to address the Reserve Bank's current concerns. The introduction of a deposit insurance scheme in the New Zealand financial sector is clearly outside the current regulatory approach of the Reserve Bank, and difficult to justify on any grounds related to economic efficiency.

### 8.5 A Trust Structure

Westpac's New Zealand operations could be reorganized under a trust structure. Westpac Banking Corporation would act as the trustee and the depositors of the bank would become unit holders in the trust. One of the key benefits of a trust structure is that it will address the Reserve Bank's concerns about the ring-fencing of the assets of the foreign bank. Additionally, the trust would not be required to be separately capitalized so would be a more efficient vehicle to ring-fence foreign bank assets compared to a local subsidiary.

We note this alternative option without having fully explored its implications or practicality in legal terms.

## **9 Conclusion**

WestpacTrust is the brand used for the New Zealand retail branches of Westpac Banking Corporation. The RBNZ has claimed that in the event of the failure of an Australian bank with branches in New Zealand there is both significant legal uncertainty about the assets that would be available to pay New Zealand depositors and significant risk that Australian directors will breach their legal obligations in New Zealand to shift assets to Australia. In either case, given the depositor protection provisions of the Australian Banking Act, New Zealand depositors may be disadvantaged. The RBNZ has introduced a policy requiring local incorporation of the

New Zealand operations of systemically-important foreign banks, claiming that this policy will materially reduce the risks faced by New Zealand depositors of foreign banks.

The local incorporation policy confuses systemic stability (the claimed basis of the RBNZ policy) with protection of retail depositors (the primary rationale for local incorporation in other jurisdictions). If local incorporation is a depositor protection policy, and is based on the notion that depositors cannot assess the risk of placing deposits with the local branches of Australian banks, then is it conceptually inconsistent with existing RBNZ policy focusing on disclosure and depositor monitoring as the primary basis for prudential regulation.

The international literature on branches and local incorporation reaches conclusions that are inconsistent with the RBNZ policy. The trend internationally has been to relax restrictions on foreign branching, with regulatory concerns being focused on depositor protection rather than systemic stability.

On the evidence available to us, it appears that the RBNZ has considered the benefits associated with local incorporation in the event that they need to manage the failure of an Australian bank, but have given insufficient weight to the efficiency losses resulting from the impact of local incorporation on the governance structure and operations of the banks in New Zealand as well as the security for depositors in the event that the local subsidiary fails. Requiring that Westpac incorporate in New Zealand (and that other banks retain local incorporation) may result in substantial efficiency losses and provide no reduction in the likelihood of loss to New Zealand depositors following insolvency.

There is strong evidence that with modern technology the branch structure represents the most efficient means of operating the New Zealand business of the Australian banks. A local board represents an inappropriate and costly governance structure for the operations of Westpac (and other Australian banks) in New Zealand. Local

incorporation may make New Zealand depositors worse off by exposing them to insolvency risk of the New Zealand operations of Westpac and removing the security of the global balance sheet of Westpac that they currently enjoy. Local incorporation, combined with the policies of foreign regulators such as APRA, substantially increases the likelihood that in the event of the insolvency of the local bank its parent will not ensure payment in full for the New Zealand depositors.

The Reserve Bank's proposal is inconsistent with its existing approach to correcting market failure in the financial sector through reliance on market discipline. The preferred option in keeping with this approach should be on informing New Zealand depositors of the unsecured status of their deposits in Westpac and allowing market forces to determine the most efficient organizational form for WestpacTrust. This policy option will address any existing information asymmetries without penalizing the operations of healthy foreign branches. In the longer term, if the Reserve Bank remains concerned with the implications of the depositor protection provisions of the Australian Banking Act, it must pursue co-operative solutions with Australian politicians and regulators that do not involve reducing the efficiency of the New Zealand banking system.

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