Parliamentary Joint Committee on Corporations & Financial Services

Inquiry into Impairment of Customer Loans – NAB's submission

August 2015

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1. Preamble

National Australia Bank Limited (**NAB**) welcomes the opportunity to respond to the Parliamentary Joint Committee on Corporations and Financial Services' (**Committee**) inquiry into the impairment of customer loans (**Inquiry**) Terms of Reference dated 4 June 2015 (**Terms of Reference**).

As a member of the Australian Bankers Association (**ABA**), NAB has participated in the ABA's consultation process and is supportive of the ABA's submission.

This submission seeks to provide further commentary and guidance to the Committee on customer loan processes specific to NAB.

NAB is Australia's biggest lender to business. We play an important role in the national economy through lending to individuals and businesses as they seek to create jobs and generate wealth.

NAB has a long history of putting the customer at the centre of everything we do. Since 2009, through our Fair Value agenda, NAB has made a number of changes to products aimed at ensuring that a fair exchange of value exists with our customers.

Impaired customer loans at NAB are dealt with through an extensive and inclusive process where our customers are supported in alleviating any challenges that exist in meeting their responsibilities.

Working constructively with our customers is NAB's priority.

In our view, there is no commercial or economic justification for a financier to artificially accelerate a default. 'Impairing' a customer's loan through a 'constructive default', as defined by the Inquiry, is not an action aligned with NAB's values.

NAB appreciates the opportunity to provide further context and detail as to its position to the Committee as it acknowledges that any potential use of 'constructive defaults' by financiers may be a matter of public interest.

2. Introduction

This submission addresses several of the Terms of Reference, and in the paragraphs that follow, provides further comments as to NAB's practices, the limited circumstances where non-monetary defaults may have appropriate and valuable application, and the role of valuers and insolvency practitioners.

Impairment of loans and 'constructive defaults'

The Terms of Reference refer to 'impairing' loans and 'constructive defaults'. NAB understands that these terms have been adopted by the Committee to refer to instances where a financier engineers an early default. This is not a practice that NAB engages in.

Changing how financiers deal with defaulting loans may have implications in light of the current regulatory framework

For Approved Deposit Taking Institutions (**ADI**s) regulated by Australian Prudential Regulation Authority (**APRA**), 'impaired loans' are defined in APRA Prudential Standard APS 220 Credit Quality.

Categorising a loan as 'impaired' has implications, including, the requirement for an ADI to hold a greater proportion of its capital against the loan, which ultimately adds to the cost of the ADI holding such loans. The regulatory and commercial implications for ADIs in restricting how they deal with defaulted loans needs to be carefully considered.

Non-monetary defaults

The Terms of Reference do not address the ways by which non-monetary defaults may have application in a broader lending experience. NAB would like to highlight that non-monetary defaults:

- provide an early warning of deteriorating risk profiles which provides opportunities for financiers to have discussions with their customers and work with customers to initiate actions to stabilise and de-risk a situation so as to avoid monetary defaults arising; and
- are essential to identifying risk relating to a certain range of loans which require customers to make only limited scheduled repayments (sometimes with lengthy time periods between those scheduled repayments). These loans include, for example:
    - commercial property construction loans;
    - certain forms of asset based finance;
    - margin lending; and
    - specialist trade finance products. For example, those which support the export of Australian goods and those which fund high value add agricultural activity.

If enforcement of non-monetary defaults was somehow restricted, it may impact the provision of funding and may have unintended commercial consequences, in the above circumstances.

The role of valuers

NAB notes that the Terms of Reference refer to 'a financial institution [that] deliberately reduces, through valuation, the value of securities'. To the extent this is suggesting financiers inappropriately participate in the valuation process, misuse valuations, or otherwise that such valuations are contrived, this is not a practice that NAB engages in. In our view, there is no commercial or economic justification for this practice.

3. Terms of Reference

Part 1

(a) practices of banks and other financial institutions using a constructive default (security revaluation) process to impair loans, where constructive default/security revaluation means the engineering or the creation of an event of default whereby a financial institution deliberately reduces, through valuation, the value of securities held by that institution, thereby raising the loan-to-value ratio resulting in the loan being impaired;
(b) role of property valuers in any constructive default (security revaluation) process;

This is not a practice that NAB undertakes in, nor is it one with commercial benefit to NAB. The use of a 'constructive default' does not align with NAB's practice or approach to dealing with our customers and NAB does not contrive the revaluation of securities for the purposes of creating loan defaults. NAB does not rely on defaults arising from deterioration in security values as a sole trigger for commencement of enforcement action where these types of defaults do arise.

<u>NAB's approach to customer financial stress</u>

NAB's approach to its customer financial distress is based on the view that prevention is better than cure. Our approach is a relationship based one with policies and processes that promote early identification of credit risk issues and interaction and dialogue with customers with the aim of working with customers to avoid situations that result in default, non-monetary or otherwise.

Where credit risk issues are identified, NAB employs a case management approach to co-manage the relationship with our customer (ie the relationship banker's involvement continues simultaneously with the involvement of specialist managers to work with customers exhibiting higher risk profiles or experiencing financial distress). Each customer is assessed and managed in response to the unique issues. As a result, there is a no "one-size-fits-all" approach adopted by NAB to deal with any one type of issue – whether that be a monetary default, non-monetary breach, or an early warning sign of financial distress that may lead to a default. NAB's aim is to discuss concerns with all customers with a view to resolving these issues as part of a mutually agreed strategy.

NAB treats all of its customers in line with these principles, including agribusiness customers, noting that NAB is a strong supporter and advocates for state based Farm Debt Mediation (**FDM**) frameworks.

NAB is aware of the stress that agribusiness customers face during times of financial hardship. Our practice is to seek to resolve the repayment of debt without enforcing loan contracts and mortgages.

FDM is a co-operative problem-solving process that NAB believes helps parties find constructive solutions to problems. Since its introduction at the State level in Australia, NAB has been a strong, consistent and vocal supporter of the process and advocated strongly for the introduction of a single national, standardised FDM process during the Federal Government's Agriculture White Paper process.

We believe that mediation by an independent third party greatly assists in the negotiation by parties to achieve their own solution to a dispute. A national FDM process from NAB's perspective gives both the customer and the lender a structured process for mediation and allows outcomes which are superior for both.

c. practices of banks and other financial institutions in Australia using non-monetary conditions of default to impair the loans of their customers, and the use of punitive clauses such as suspension clauses and offset clauses by these institutions

Non-monetary conditions

NAB is required by APRA Prudential Standard APS 220 Credit Quality (and under various policy and accounting standards) to recognise impairment as and when it occurs. Non-monetary defaults can be a trigger for a loan to be recognised as impaired. This is not a discretionary decision taken by NAB, but rather, is one of complying with imposed prudential requirements.

NAB views a non-monetary default as the basis for a discussion with the customer to agree a strategy which addresses or mitigates the risk that the non-monetary default is highlighting.

NAB will only use non-monetary events of default in limited circumstances to commence enforcement action, mostly commonly confined to an insolvency event associated with the customer (that is where the customer, its directors or another third party has placed, or has taken formal steps to place, the customer in external administration).

Use of suspension clauses

NAB, like most banks, has within its loan and security documents clauses which require its customers, and their guarantors, to repay a loan in full without “any set-off, counterclaim or deduction”. These are commonly referred to as “suspension clauses” (by virtue of them suspending or postponing the rights of a customer or guarantor claiming against NAB until the loan has been repaid).

The courts, when called on to consider these clauses, will limit their use to instances where a customer or guarantor, while making a claim, is not also challenging the validity of the debt or guarantee.[1]

NAB does not, and has no intention or desire to use these clauses in a way which could be considered punitive. In addition, NAB considers that even within their court recognised limitations, there are still very few instances where it is appropriate to be before a court seeking to rely on these clauses. Such an instance would only be where NAB has first considered the customers’ /guarantors’ circumstances.

d. role of insolvency practitioners as part of this process

Use of Insolvency Practitioners

The use of insolvency practitioners as external administrators is a legitimate enforcement option. However, as with all enforcement activity, it is not a decision NAB takes lightly and is usually after an extended period of having attempted to resolve the situation with our customer.

Insolvency practitioners are used where the activity associated with a recovery is deemed to be complex or requiring the legal powers associated with those afforded under relevant legislation. It is a necessary option for example where a trading business is involved to protect the value of a business and/or assets for the benefit of all stakeholders, customers, employees and creditors.

[1] *O’Brien v Bank of Western Australia Ltd* [2013] NSWCA 71.

Role of Insolvency Practitioners

Where there has been a material deterioration in a customer's risk profile then NAB will consider engaging specialist restructuring and insolvency firms to conduct an Independent Business Review to provide an overall view of the risks facing the business. On occasion, where significant risks are identified, management is unable to address those risks, and defaults are continuing, then NAB may appoint receivers.

Australian financiers typically appoint the restructuring and insolvency firm that conducted the Independent Business Review, to take advantage of the knowledge that they have of the business and thereby minimise costs.

e. implications of relevant recommendations of the Financial System Inquiry, particularly recommendations 34 and 36 relating to non-monetary conditions of default and the external administration regime respectively

Recommendation 34

Approval of credit for a customer involves a point in time assessment of the future prospects of a customer. The factors taken into consideration in a credit assessment, and following, inevitably vary over time as the factors impacting upon a customer also change. Non-monetary covenants provide an important insight into the performance of a customer over time. Non-monetary covenants are designed specifically for each customer to provide key indicators of deteriorating risk factors that may lead to a monetary default and / or loss to the customer and NAB.

Whilst NAB does not, as a matter of practice, take enforcement action solely in response to non-monetary events of default (outside of the limited instances of an insolvency event associated with the customer), they remain of significant value as a source of information and as an important discussion point with customers that are often the impetus for action to be taken by the customer to seek to avoid monetary default.

Additionally, it is NAB's view that a restriction of creditors' rights to utilise non-monetary defaults may lead to situations where creditors either seek additional security coverage and/or reduced credit risk appetites for a range of transactions.

Given NAB's approach to the use of non-monetary defaults, we do not consider an industry standard on the use of non-monetary defaults or changes to the unfair contract term protections to small business is required. That said, NAB would not object to changes to the Code of Banking Practice that provide greater transparency around the use of non-monetary defaults. NAB would however, object to a restriction on the use, or dilution, of a creditors' ability to require non-monetary defaults to form part of its credit agreements with customers as they form an important element of NAB's credit risk framework and any changes in this area would result in significant additional implementation and monitoring costs.

NAB notes that legislation – the *Treasury Legislation Amendment (Small Business and Unfair Contract Terms) Bill 2015* – is currently before the Commonwealth Parliament. If legislated in its current form, this Bill will potentially impact upon the use of non-monetary default covenants in small business contracts between banks and their customers. NAB supports the significant concerns expressed by the ABA in its submission to both this Inquiry as well as the current Senate Economics Legislation Committee's Inquiry into the Bill.

This Bill mitigates against the ability of banks to manage their risk exposures and consequently makes lending to small business more difficult. Under this proposed legislation, a court decision to declare a clause in a standard-form contract unreasonable (and subsequently void) would potentially have a systemic impact upon lending across the sector. NAB believes our record in not seeking to utilise non-monetary defaults is illustrative of a financier that exercises rights under these contractual clauses cautiously and responsibly.

Recommendation 36

NAB refers to its submission to the Final Report of the Financial System Inquiry.

NAB does not support the implementation of a 'Chapter 11' regime in Australia. Like the UK and USA, Australia already has an environment which supports and encourages business turnarounds outside the court process. NAB believes that there are a number of ways in which the current environment could be improved, so as to assist the restructuring process and lower its cost.

(a) Australian regime already supports business turnarounds 'out-of-Court'

Public confidence is vital for businesses. Doubts over financial viability will cause a loss in sales and profits, as well as a loss of liquidity when suppliers reduce or eliminate credit. For this reason, out-of-Court restructuring is the preferred mode in Australia, the UK, Canada and the USA. The absence of publicly reported restructuring in Australia is not an indicator that financial restructuring does not occur.

NAB's experience as Australia's leading business bank is that large corporates are usually able to restructure out-of-Court, with little loss of confidence, limited adverse impact to trade creditors and contractors and with minimal job losses.

(b) Australia should not implement a 'Chapter 11' regime

The US 'Chapter 11' regime is comprehensively different to Australia's Voluntary Administration (**VA**) regime. NAB believes that the extent of these differences may not be well understood by all of those who propose a Chapter 11 style regime for Australia. The differences are many, but we would specifically highlight the following:

- Chapter 11 allows employers to break labour contracts and retirement pension arrangements and to renegotiate them. Implementation of such a regime in Australia would represent a change of unprecedented scale and is unwarranted, as there is no evidence to suggest that Australia's existing industrial relations regime is currently an impediment to corporate restructuring.

- Under Chapter 11, even routine business decisions, such as the closure of unprofitable stores, require Court deliberation and approval. With various stakeholders represented by lawyers, paid for by the company under reorganisation, Chapter 11 becomes slow and extremely expensive.

- In 2011, the American Bankruptcy Institute (**ABI**) launched a three year review of the Chapter 11 process.[2] The ABI was concerned that Chapter 11 is increasingly becoming more of a takeover tool and less a regime by which management was assisted to restructure its own business.

Australia's current VA regime serves two purposes:

1) It offers a quick and inexpensive pathway into liquidation for the majority of SME businesses for which restructure is not viable; and
2) It offers a relatively inexpensive option for SME businesses that can be restructured.

NAB believes that the VA regime in its current form is not best suited for large corporate restructuring, but that it can be modified to better suit large restructuring. NAB believes that this

[2] *"ABI Commission to Study the Reform of Chapter 11",* June 2011.

would be a better alternative to the wholesale adoption of a Chapter 11 regime, a view we share with the Australian Restructuring Insolvency & Turnaround Association and the Turnaround Management Association.

(c) The VA regime and aspects of the Australian legal system could be improved to assist restructuring

The insolvent trading regime creates an inherent conflict between a director's personal liability and otherwise acting in the best interests of company creditors, by imposing personal liability on directors if they allow their company to trade whilst insolvent.

It is very difficult for large distressed businesses to operate on a cash basis. Where there is uncertainty, the only means currently available by which directors can avoid personal liability is to place their company into formal insolvency. This is irrespective of the fact that they may think this is not in the best interests of the company or its creditors (including employees).

NAB believes that the insolvent trading regime focuses directors' attention on their duties and responsibilities in the context of insolvency. However, in certain circumstances, it creates an inherent conflict between a director's personal liability and the interests of the company and its creditors. This compromises the director's attempts to initiate a business restructuring.

The law should be modified to provide directors with clearly defined "safe harbour" protections, when directors reasonably form the view that it is in the best interests of the company to implement a restructuring plan. This will assist in avoiding formal insolvency when a restructuring plan may have provided a better outcome for all company stakeholders – creditors and employees included.

(d) Automatic "termination for insolvency" can act as an incentive to terminate contracts

Automatic "termination for insolvency" clauses (i.e. "ipso facto") in commercial contracts and performance guarantees can provide counterparties with an opportunity and economic incentive to terminate an otherwise performing and compliant contract. This could result in liquidation, rather than support an otherwise viable business recovery.

Many businesses have commercial contracts for the provision of a range of services and contractual rights, for example, supply and maintenance facilities, leases, franchise agreements, dealer or distributorship agreements, and licensing arrangements. Many are also supported by performance guarantees. These contracts invariably contain clauses that result in automatic termination upon insolvency. Performance guarantees are invariably called as a result. Under both the Chapter 11 regime and Australian personal insolvency laws, these clauses are void. However under the VA regime, there is a more limited but critically temporary moratorium, which ends once the company enters into a Deed of Company arrangement. These contracts (which often comprise the majority of the enterprise value) are no longer available to administrators seeking to revive a business.

The general moratorium currently existing in the VA regime should be extended to cover these contracts, or specific provisions implemented to abolish contractual rights of counterparties to terminate contracts, solely on the basis of the appointment of administrators to a company.

(e) Limited scope for Pre-packaged Administrations to facilitate restructuring

The VA regime provides limited scope for Pre-packaged Administrations to facilitate business restructuring and to preserve value. With appropriate safeguards (to avoid "phoenix transactions", conflicts of interest and consequential changes to the provision of business credit) we believe that improvements would be achieved.

Pre-packaged Administrations are a common UK mechanism to facilitate restructurings and preserve value. These types of restructurings have proven to be very beneficial for UK retail and services businesses where goodwill and trading value can dissipate quickly. NAB has successfully participated in these restructurings in the UK. The Australian legal system and the commercial practicalities of restructuring in Administration make it very difficult to implement a pre-packaging arrangement. NAB considers that further investigation and debate on the merits of making it easier to implement Pre-packaged Administrations is warranted.

f. extent to which borrowers are given an opportunity to rectify any genuine default event and the time period typically provided for them to do so

NAB considers exercising its rights in response to any event of default on a case by case basis and as part of the whole set of a customer's financial position and particular circumstances. The time period provided to rectify an event of default depends on these factors and an assessment of, among other things:

- whether the default is capable of being rectified;
- the likelihood of rectification;
- other actions agreed with the customer as part of an overall plan to address the event of default; and
- whether the assets of the business and the security are deteriorating or have a limited life or there are other factors such as animal welfare.

g. provision of reasonable written notice to a borrower when a loan is required to be repaid

As explained above, NAB's approach is one of early identification and continued dialogue with our customers. Where the decision is made to end the relationship with the customer and require repayment of loans, that intention will be addressed with the customer and often result in a negotiated agreed timeframe for repayment, in excess of the time allowed for in the loan agreements or applicable statutes. The timeframes are determined on a case by case basis having regard to the customer's particular circumstances. Depending on the loan size and complexity time frames will vary. Providing a customer is making satisfactory progress towards repayment, is still considered capable of achieving repayment and the credit risk is not otherwise increasing to NAB's detriment, further time is likely to be provided to customers to ultimately repay amounts owing to NAB.

It is our practice for all time frames applying to a customer, whether as the result of a negotiated forbearance period or enforcement action, to be clear and recorded in writing to the customer.

NAB does not consider that there is any need to impose any further compulsory notice periods in addition to the current applicable, and appropriate, statutory notice periods. Current statutory notice periods apply depending upon the enforcement step, lending type or industry (for example, consumer credit, farm debt, mortgagee sale).

h. appropriateness of the loan to value ratio as a mechanism to default a loan during the period of the loan

As noted above, non-monetary defaults such as LVR covenants:

- Provide an early warning signal that allows financiers to make loans that might otherwise be regarded as "too risky" because there is inadequate bricks and mortar security.

- Are essential in identifying risk relating to a certain range of loans which require customers to make only limited scheduled repayments (sometimes with lengthy time periods between those scheduled repayments). These loans include, for example:
  - commercial property construction loans;
  - margin lending;
  - certain forms of asset based finance; and
  - specialist trade finance products for example those which support the export of Australian goods and those which fund high value add agricultural activity.

If enforcement of non-monetary defaults was somehow restricted, it is likely the provision of finance in the above circumstances would be impacted.

i. conditions and requirements to be met prior to the appointment of an external administrator

The rights currently afforded to creditors to appoint an external administrator are prescribed by the *Corporations Act 2001* (Cth) (**Corporations Act**) and the contractual terms and conditions of the lending and security documents.

Enforcement action is a very serious decision that NAB will only ordinarily exercise after an extended period of having attempted to resolve the situation with our customer.

Notwithstanding NAB may be within its rights to appoint an external administrator based on a non-monetary default, it would only be in limited circumstances (for example an insolvency event addressed above), where NAB would exercise that right.

NAB's approach is to work with our customers to endeavour to address any events of default, or pending events of default, in order to avoid enforcing its securities. This course of action is only taken after other acceptable alternatives have been exhausted. NAB's experience in this regard is that enforcement can lead to poorer overall outcomes.

NAB's decision making framework is structured so that the authority to make an external administration appointment is held by a limited number of NAB's experienced personnel.

Part 2

d. the adequacy of the legal obligations on lenders and external administrators (including s420A of the Corporations Act 2001) to obtain fair market value for the forced sale of property

<u>Section 420A</u>

Where NAB, or a Receiver/Controller appointed by NAB, exercises a power of sale there are strict legal obligations which they each are required to comply with.

Where property is owned by a company, NAB, or a Receiver/Controller appointed by NAB, (under section 420A of the Corporations Act) is required to take all reasonable care to sell that property for not less than its market value, or otherwise (where there is no market value), to sell the property at the best price reasonably obtainable, having regard to the circumstances existing when the property is sold.

These requirements are in addition to a Receiver/Controller's overarching obligations (as an officer of the company) to act in good faith, for a proper purpose, with care and diligence, and to avoid conflicts of interest (sections 180, 181, 182, 183 or 184 of the Corporations Act).

Where property is owned by an individual, there are also similar requirements under State legislation (for example, section 111A *Conveyancing Act 1919* (NSW), and section 85 *Property Law Act 1974* (Qld)).

Additionally, the *Personal Property Securities Act 2009* (Cth) imposes similar obligations on secured parties when disposing of collateral.

Broadly, these legal requirements (together with the common law duties) have been the subject of extensive judicial consideration. As a result, these laws have been well tested and there is significant guidance around what practical steps and identifiable processes (for example, advertising and the manner of sale) may be appropriate to employ in order to discharge the duties set out above. It is noted that these duties require a high standard to take all reasonable care (not simply reasonable care).

Importantly, in our view, these practical steps and identifiable processes have been developed having regard to the protective purpose of these laws – to ensure mortgagors' property is not sold at less than market value, when that sale process is no longer in their control.

Court cases evidence that relief under section 420A is readily accessible by creditors and other interested parties to seek to contest whether a Receiver/Controller has discharged his or her obligations in exercising a power of sale in respect of property of a corporation.

<u>Reform of section 420A</u>

The Productivity Commission's proposal to introduce a further duty (whether in section 420A or elsewhere in the Corporations Act) for a Receiver/Controller not to cause unnecessary harm to the interests of creditors as a whole, including putting the continuation of the company, or the preservation of the company as an ongoing concern for sale purposes, may lead to increased litigation at a time when the business is in financial crisis.

NAB is supportive of the ABA's recent submission to the Productivity Commission's *Business Set-Up, Transfer and Closure Draft Report* on this topic:

> These amendments would significantly alter the rights of secured creditors in circumstances where there does not appear to be any market evidence to support a suggestion that in selling assets, receivers have caused "unnecessary harm to the interests of creditors, as a whole".
>
> Further, the proposed duty would be vague and difficult to interpret, for example, what are interests of creditors as a whole that must not be unnecessarily harmed or, must the Receiver refrain from exercising the power of sale if it is foreseeable that realisation of the company's assets could result in a risk that the company may not remain as a going concern for ultimate sale? This would create an uncertain and unworkable situation in which a Receiver must make a decision.
>
> The existence of section 420A ensures that the company and unsecured creditors are already protected by the section, which requires a Receiver to sell at market value, if there is a market value.
>
> The additional processes by which creditors of the company might vote on a sale of the company's assets would introduce significant complication and costs to the realisation process.
>
> The additional processes would be likely to slow down the realisation process as it would likely include a need for classes of creditors to be identified for voting purposes including advertisements calling for creditors' claims and evaluating their proofs of debt for voting

purposes, separate voting arrangements for each class of creditors all of which would add cost to the receivership.

A problem in calling for creditors' claims is the prospect that this will be taken up at large as an invitation for claims against the company, irrespective of the legitimacy of those claims all of which would have to be assessed and decided upon. Inevitably, rejection of some claims would be disputed creating further cost and delay.