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AUSTRALIA

21 March 2016

The Committee Secretary
Parliamentary Joint Committee on
Corporations and Finance Services
PO Box 6100
Parliament House
Canberra ACT 2600

Re: Inquiry into the impairment of customer loans

National Australia Bank Limited ("**NAB**") appreciated the opportunity to appear before the Parliamentary Joint Committee on Corporations and Financial Services ("**Committee**") at the public hearing held on 18 November 2015 in Sydney.

NAB has now provided the Committee with responses to the questions on notice put to NAB by the Committee at that hearing.

The Committee has separately written to NAB, by letter dated 2 December 2015, requesting it respond to an additional 18 questions on notice.

NAB attaches its response to 17 of those 18 questions.

Should the Committee require any further information once it has an opportunity to consider NAB's responses, NAB would be happy to assist in the provision of further information.

Yours sincerely,

JUSTIN OWEN
Senior Manager – Government Affairs and Public Policy

Questions on Notice

Question 1: When valuations and revaluations are sought, does the bank use registered certified property valuers?

Our policy requirement is that external valuations are conducted by registered certified property valuers. On occasion this requirement is waived for new loans and internal valuations used, to reduce costs. Typically this would be in relation to an Agri-Business loan, for example where a farmer buys an adjacent block from a neighbour we might use the per hectare value from a recent external valuation of an adjacent property.

If we were contemplating a default we would always use a valuation conducted by an independent registered certified property valuer.

Question 2: Where the committee has received submissions relating to NAB matters, could you advise the committee if the valuers used by the bank in those cases were registered certified valuers?

Where the committee has received submissions relating to NAB matters, any valuations commissioned by NAB in those matters were provided by independent registered certified valuers.

Question 3: How does securitisation work in relation to commercial loans?

a. What happens if the loan is defaulted and foreclosed?

b. What involvement does the purchaser of the securitised loan have in the in the default and foreclosure process?

c. If there is net loss from winding up a loan, is the loss borne by the bank originating the loan or the purchaser of the securities loan?

NAB does not have any commercial loans that are currently being securitised and have not done so since before the GFC (ie August 2008). NAB may consider securitising these types of commercial loans in the future.

During the period 2012 to 2014, NAB securitised commercial loans provided by Medfin Australia Pty Ltd ("Medfin"). Medfin is a wholly owned subsidiary of NAB. The response to each of the above questions in respect of these securitised loans is set out below.

Part A

The securitised Medfin loans would be serviced by Medfin in the normal way. If the customer defaulted resulting in the security/ies being enforced, proceeds from the sale of the security/ies would be paid to the securitisation trust, with surplus proceeds returned to the entity that sold the loan to the securitisation trust (ie. Medfin).

Part B & C

The securitisation trust, as 'owner' of the loan, would rely on the servicer (ie. Medfin) to enforce payment of the loan and any security/ies. The purchaser of the securitised loan (the securitisation trust) would bear the loss. Prudential Standard APS 120 requires credit risk to be transferred to the securitisation trust.

Question 4: What are the costs of the following:

a. Investigative accountants

b. Insolvency practitioners

The cost of an Investigative Accountant's Review will vary with the scope of the review and the size and complexity of the business, ranging from \$5,000 for a small business with one location to several hundred thousand dollars for very large businesses with multiple lines of business operating in multiple locations in several countries. For a standard small to medium size business the more typical cost would be in the range of \$25,000 to \$45,000.

The fees charged by insolvency practitioners for formal insolvency appointments are calculated by reference to hourly rates set in master service level agreements. They will vary considerably with the size and complexity of the business and the time that is taken to realise all assets and assess claims.

Question 5: What are the default interest rates currently in place for residential, small business and commercial customers? How do they vary from the standard loan rates?

Residential loans and credit cards

NAB's home loan products do not currently charge default rates. For completeness, there are some legacy home loan products that may apply default rates.

Consumer and commercial credit card products charge interest on purchases, cash advances and balance transfers. No consumer credit card product offered by NAB includes a separate default rate (higher) where payments are in default.

Business and commercial loans

NAB's current standard default margin applicable to business and commercial loans is 4.5% per annum. This default margin is charged in addition to the contracted interest rate.

Question 6: What are the costs that might flow from early intervention as discussed by NAB at the 18 October hearing? What processes might the banks instigate that are then paid for by the owner of the property?

Early intervention should reduce the chances of there being any additional cost such as valuations and investigative accountants' reviews.

Question 7: Can a single default trigger action by a bank?

Yes.

Question 8: Should builders contracted by property developers be advised if the developer's fund release is frozen?

Sometimes drawdown requests are delayed or partly deferred pending the receipt of further information or supporting documentation.

If funding is completely withdrawn the developer already has a duty to avoid insolvent trading, and so should cease work unless they can arrange alternate sources of funding in the short term.

We see the merit in requiring disclosure if funding is withdrawn after a short "grace period". However, we highlight that this would need to be a legislated obligation because currently we are required by common law, the Code of Banking Practice, and our loan documentation to maintain customer confidentiality.

Question 9: What are the incentive structures that apply:

a. for staff who set up loans; and

b. for staff who are in credit management departments who are involved with loans in financial

c. distress, default or impairment.

Part A

Staff involved in loan establishment fall into a number of categories. There are those employees who are involved in dealing directly with personal and business customers to determine the customers' needs. There are also support employees who are involved in establishing loans once documentation is received.

Within the Retail sector, **Branch employees** involved in offering products to customers participate in a specialist incentive plan.

- Payments under the plan are made six monthly.
- To receive a payment an employee must meet required performance expectations across a balanced scorecard consisting of both financial and non-financial performance objectives (covering financial, risk, employee and customer measures). In addition, they must demonstrate that they are meeting a threshold level of performance against our Values.
- Revenue points are allocated to staff based on the products sold. The points are then modified based on the employees overall performance and values outcome for the 6 month period.
- A portion of the incentive payment above a threshold is subject to deferral for a 12 month period. During this period, the employee must remain employed by the NAB Group and must meet mandatory compliance requirements.

Incentive payments are subject to a number of governance procedures to ensure appropriate outcomes including ongoing monitoring and oversight of the plan, clawback of points and risk oversight of outcomes.

Within the Business sector, the majority of **employees** involved in offering products to customers participate in the Group Short Term incentive plan.

- Payments under this plan are made on an annual basis.
- Each employee has a % target. This is calculated as a % of their base salary. To receive a payment an employee must achieve a required level of performance against a balanced scorecard of objectives which includes financial, risk, employee and customer measures.
- The employee must also achieve threshold performance against our Values and conduct requirements. Not meeting any of these requirements will result in no incentive payment.
- The incentive pool is based on overall Group performance against a number of key metrics. The pool is reviewed and approved by the Principal Board.
- Individual outcomes are dependent on individual performance and values outcomes.

A small group of specialist relationship managers (approximately 30) participate in the Medfin Incentive plan. This plan is similar in structure to the Retail Sector Branch employees plan. Payments under this plan are made monthly.

Employees involved in processing of documentation relating to loan applications participate in the Group Short Term Incentive plan. This is the same plan that applies to the employees in the business sector and detail of the structure is outlined above.

Part B

Employees within credit management departments participate in the overall Group Short Term Incentive plan as described above.

Part C

Employees within departments that deal with distress, default or impairment only participate in the overall Group Short Term Incentive plan as described above. As is the case for the Business sector employees, employees within departments that deal with distress, default or impairment must achieve a required level of performance against a balanced scorecard of objectives which includes financial, risk, employee and customer measures. Some employees have measures that are linked to the timely management of an overall portfolio of impaired loans, however no employees have a direct incentive to impair or enforce a loan.

Question 10: What incentive structures applied since 30 June 2008, including any special arrangements that may have occurred at particular times, such as during the GFC or following acquisitions of other banks?

All plans described in this document have existed since prior to 2008. Changes are made to scorecard measures and incentive frameworks from time to time, however the broad structure of these incentive frameworks have remained the same.

Question 11: Please provide information on the extent to which receivers are seconded into banks to work with distressed, defaulted or impaired loans.

a. Please also set out the arrangements for ensuring that there are no conflicts of interest in the appointment of investigative accountants and receivers.

b. Please provide information on the number of occasions in which the above arrangements have been breached and what consequences were applied to those responsible.

From time to time, staff from insolvency firms are seconded to work into NAB's workout area to assist with variations in work levels. The percentage of secondees would be less than 10%, often much less than 10%.

The appointment of Investigative Accountants and Receivers are significant decisions which require the approval of a senior member of the workout team, and a secondee would never be in a position to make any kind of appointment of any person on their sole authority.

As a matter of practice if a secondee was involved in the management of a file whilst at NAB we would not approve the appointment of the secondee's employer as an Investigative Accountant or a Receiver.

We are not aware of any breaches of these arrangements.

Question 12: Where the NAB requires a property used as security to be revalued and the borrower is required to pay for the valuation:

a. could a copy of the valuation and the banks instructions to the valuer be provided to the borrower?

b. what review processes are available to the borrower if they disagree with the valuation?

Our current arrangements prevent the bank from providing a copy of a valuation to the borrower. This is a requirement of the valuers, rather than a condition imposed by NAB.

NAB would not object to the provision of a copy to borrowers but we would need the valuer to agree to the disclosure.

Noting that the first valuer is typically chosen by the borrower (from a list of three panel firms), we will often agree to a second valuation in the event that the borrower disagrees with the outcome of the first valuation. This is a matter of practice rather than a formal policy.

Question 13: The Code Compliance Monitoring Committee informed this committee that the Banking Code of Practice does not include any requirements regarding revaluations or impairment. Would it be possible for the Banking Code of Practice to include revaluation and impairment in future?

NAB understands that the Code of Banking Practice (**Code**) requires the Australian Banking Association (**ABA**) to commission an independent review of the Code every 5 years, or earlier at the Code Compliance Monitoring Committee's (**CCMC**) request. Such review is required to be conducted in consultation with banks which adopt the Code, small business and consumer organisations, other interested industry associations, relevant regulatory bodies and other interested stakeholders.

Any amendments to the Code, including any requirements regarding revaluations or impairment, could form part of this review process. This would ultimately be a matter for the ABA and CCMC.

Question 14: The committee has heard that the jurisdiction of the Financial Ombudsman Service is limited to loans below \$500,000.

a. Would it be possible for that limit to be increased, as a significant proportion of residential and small business loans may exceed that amount?

b. What dispute resolution arrangements are available to borrowers whose loans are over that amount?

Part A

NAB maintains a positive, open and constructive relationship with FOS. This has been reflected in the level of engagement both in relation to individual complaints and systemic issues. NAB believes that a free, effective and independent industry scheme is integral to building and maintaining consumer confidence in the industry.

NAB's view is that any increase or expansion of FOS' jurisdiction would require careful consideration around resourcing and capability of FOS.

Part B

NAB has a 1800 number (available on our website) which customers can call to speak to someone at NAB about a complaint. Complaints are addressed by a well-qualified team within NAB, NAB Resolve.

If a customer is not happy with the outcome that NAB Resolve have suggested, complaints may be escalated within NAB, including to the executive office. If a complaint comes to NAB's Strategic Business Services teams, it is reviewed, usually by senior staff within that team in conjunction with NAB's internal legal team. If the circumstances require it, we may look to have the customers file reviewed independently.

We work through complaints with our customers, as our objective is to ensure a high level of customer satisfaction and ultimately the retention of our customers.

Question 15: In your submission (page 4) you noted that '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'.

a. Could that create an incentive for banks to avoid impairing loans?

b. What mechanisms are in place to ensure that banks do not avoid impairing loans in order to avoid the increased costs associated with holding extra capital?

We agree that the additional capital costs resulting from holding impaired loans provide banks with some level of financial incentive to delay impairment - rather than accelerate impairment, which we understand to be the concern that this committee is investigating.

There is extensive regulatory supervision by APRA as well as strong corporate governance frameworks including internal and external audits and risk and supervisory oversight, to ensure that that NAB does not understate the level of impaired loans.

Question 16: In your submission (page 4) you indicated that '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'.

Could you provide further information to the committee on the impact on the provision of funding and unintended commercial consequences?

Non-monetary covenants create an early warning system which allow banks to accept higher risk loans, particularly for loans that do not currently have any interim payments requirements or are interest only.

If enforcement of non-monetary defaults was somehow restricted such that lenders could only enforce on payment default, it is likely that:

- Loans that currently have no payment requirements might be restructured to require regular payments – thereby impacting the borrower's cashflow
- Loans that are currently interest only might be restructured to require principal payments – thereby impacting the borrower's cashflow
- Riskier loans might not be made at all.

Question 17: How precise are the accounting standards that define whether or not a loan is impaired? Where NAB has identified a set of loans that it considers to be impaired, are those accounts audited by an external auditor, and did the auditor recommend any variations to the impairment provisions?

The definition of impairment is set by our regulator, APRA. We consider that the definition is clear and well understood.

Our compliance with that policy is carefully reviewed by our external auditor both as to whether a loan is impaired or not and if so, the level of provisioning.

Noting that provisioning is a subjective decision and that the auditor's assessment is conducted with the benefit of information available after balance date, our auditors will occasionally suggest an adjustment to the provisioning but this has never been to the extent requiring disclosure as "material."