

# **NAB's submission in response to the Final Report of the Financial System Inquiry**



**nab**

more give, less take

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# 1. Introduction and Overview

National Australia Bank Ltd (NAB) appreciates the opportunity to make a submission to Department of Treasury in response to the Final Report of the Financial System Inquiry ('FSI' or 'the Inquiry').

As a member of the Australian Bankers Association (ABA), NAB continues to participate in the development of the ABA's response on behalf of the banking industry and, as such, we are broadly supportive of the ABA's response to the FSI's Final Report.

NAB considers the FSI to have been a necessary and important process. NAB is supportive of initiatives that seek to improve the efficiency and stability of the Australian financial system and we agree with many, though not all, of the Inquiry's recommendations. Taken together, we believe that the recommendations will contribute to the development of a financial system that is efficient, resilient and fair.

This submission discusses 15 of the Inquiry's 44 recommendations, which are those areas where NAB believes its position can assist Government and regulators in implementation.

With respect to the areas addressed in this submission, NAB believes that the following issues will be crucial in ensuring successful implementation of the FSI's recommendations:

- **Resilience:** Changes to Australia's regulatory framework must be compatible with international regulatory developments. As such, they should not run ahead of the Basel Committee on Banking Supervision (BCBS) agenda, which is likely to result in material changes to capital standards for banks globally. Implementation timing must take into account the size and characteristics of Australia's capital markets, to avoid any market dislocation. The characteristics that define an 'unquestionably strong' financial system are broader than just capital alone and a range of other attributes should also be considered by regulators when determining appropriate prudential standards. Implementation should be undertaken on a 'principles-based' approach.
- **Superannuation and retirement incomes:** Since the introduction of compulsory superannuation over 20 years ago, Australia's pool of retirement savings has grown to be the second largest component of the Australian financial system. Numerous changes and reforms over that time have detracted from its core aims. NAB agrees that it is time to reaffirm and commit to superannuation's original intent. In the accumulation phase, NAB supports initiatives that will create better member engagement and higher after fee returns. In the retirement phase, NAB already offers a range of solutions that meet many of the objectives identified by the Inquiry and we endorse trustee pre-selection of a robust retirement income product as a preferred solution for a broader range of retirees.
- **Consumer outcomes:** NAB agrees with the Inquiry that reliance on current disclosure and financial literacy models alone are not sufficient to protect consumers. Greater safeguards are needed. In this regard, much of the product design and distribution processes that the Inquiry recommends are already in place in best practice organisations, including NAB. More innovative and tailored approaches to disclosure and engagement would strengthen the system. For this reason, we encourage the Australian Securities and Investments Commission (ASIC) to work closely with the industry to develop an implementation approach that strikes the right balance between consumer protection, product innovation and efficiency.

## 2. Resilience

### FSI Recommendation 1: Capital levels

*Set capital standards such that Australian authorised deposit-taking institution (ADI) capital ratios are 'unquestionably strong'.*

#### Summary of NAB's position:

NAB agrees that Australian bank capital ratios should be viewed as 'unquestionably strong', but defining strength through one capital measure alone is insufficient to achieve this outcome. Instead, NAB believes that it is necessary to consider the full risk profile of the individual institution, as well as the attributes of the Australian financial system. Instead of introducing another capital metric, NAB recommends that the Australian Prudential Regulation Authority (APRA) include peer comparison into its existing supervisory framework. To achieve greater international comparability of capital ratios, consideration should be given to harmonising capital ratios to the Basel framework.

#### Definition of unquestionably strong capital ratios:

The Global Financial Crisis (GFC) highlighted the importance of financial system resilience and the role that capital adequacy plays in protecting banks. As net importers of capital, Australian banks must compete for funding in international markets. In order to facilitate access to funding, Australian bank capital ratios need to continue to be viewed as 'unquestionably strong', during a time in which Australia and other countries are implementing regulatory change.

NAB agrees with the guiding principles articulated by the FSI. However, in NAB's view, by focusing on one capital ratio alone, the FSI recommends a measure of strength that is too narrowly defined. Instead, it must consider the complete risk profile, both of the individual institution and of the regulatory environment in which the institution operates.

This includes:

##### Institutional specific factors

- Balance sheet composition and liquidity structure;
- Funding profile;
- Credit, operational, business and other risk exposures;
- The sophistication of risk management tools and frameworks; and,
- Corporate governance and oversight.

##### Systemic factors

- Types of activities undertaken and the markets in which we participate;
- The nature and level of prudential supervision; and,

- A strong and credible central bank that offers liquidity support in extreme circumstances.

The Inquiry highlights that APRA is best placed to determine the appropriate implementation of each of its capital adequacy recommendations. NAB recommends that the Government remain 'principles-based' in its approach to implementing the FSI's recommendations. It should allow APRA the opportunity to set capital requirements through detailed industry consultation in line with normal practice for regulatory change and should also recognise emerging regulatory themes from the BCBS.

#### Determining the appropriate minimum capital requirement:

The Inquiry's conclusion that Australian ADIs should have a baseline target capital ratio in the top quartile of internationally active banks is an arbitrary measure, for the following reasons:

- Australian banks are currently recognised as being amongst the strongest in the world. International investors have not expressed concern with Australian bank capital levels as they stand today.
- Peer benchmarking is only one element of relative capital strength, albeit an important one.
- Setting minimum capital levels based on a moving target creates uncertainty and unintended consequences. It could also lead to a perpetual feedback loop. If adopted, it could introduce a 'pass/fail' element, which would push banks to hold buffers well above even the 75th percentile.
- In determining a baseline target capital ratio, comparisons to international banks need to consider an appropriate peer set and a harmonised view of capital ratios. This is a complex exercise, due to the different applications of the Basel rules across multiple jurisdictions. This issue is further addressed as part of NAB's response to Recommendation 4.

NAB suggests that APRA set an absolute minimum capital requirement, rather than a relative minimum capital requirement, with the flexibility to review this on an ongoing basis. Peer analysis is already a key component of NAB's capital adequacy framework and is regularly refreshed and addressed in capital settings.

APRA should formally consider comparisons of Australian banks versus an appropriate international peer group within its existing supervisory approach and prudential capital requirements, as necessary, rather than introducing a new moving benchmark.



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### ***Establishing a harmonised view of capital ratios:***

NAB notes that APRA has often been a ‘first mover’ in establishing compliance with Basel capital framework requirements. As expectations continue to be raised in defining capital adequacy, NAB recommends that APRA re-examine its settings in light of global developments and reaffirm appropriate minimum capital requirements for Australian banks, whilst taking into consideration the Australian banking industry’s specific risk profile. With an increasing focus on international comparisons, consideration should be given to harmonising the calculation of capital ratios to the Basel framework.

### ***Implementation mechanisms:***

While NAB agrees that the minimum requirements for capital adequacy are increasing, NAB views the current Higher Loss Absorbency buffer at 1% for Domestic Systemically Important Banks (D-SIBs) to be appropriate. As the FSI Final Report recommends, incremental capital requirements should be applied across all Australian ADIs, so as to ensure the stability of the entire Australian banking system.

In considering potential uplifts to current capital requirements, NAB recommends that APRA review the mix of Common Equity Tier 1 (CET1) capital, Additional Tier 1 (AT1) and Tier 2 (T2) capital and determine whether a proportion of this increase is better satisfied with AT1 or T2 instruments. Both AT1 and T2 instruments provide additional loss absorbing capacity for banks, whilst allowing greater efficiency and flexibility within the capital structure.

### **Conclusion:**

NAB supports the principle that Australian bank capital ratios should be viewed as ‘unquestionably strong’ and notes that the international investor community currently views Australian banks in this way. In defining financial strength by tying capital ratios to the top quartile on a harmonised basis, the Inquiry has added unnecessary complexity to the capital framework and any relative assessment should also consider other bank attributes assessing financial strength.

Instead, NAB recommends that APRA integrate positioning versus global peers into its existing supervisory approach and prudential capital requirements, building upon its current practice today. APRA should also consider harmonising capital requirements to the Basel framework, as appropriate, to better facilitate international comparisons.

Any change to the capital setting framework must ensure that transition timelines are sufficient to prevent market instability, avoid significantly increased funding costs and allow time to remediate any unintended consequences. To the extent possible, regulators should look to improve transparency with respect to the capital framework and remove uncertainty in relation to regulatory change.

## FSI Recommendation 2: Narrow mortgage risk weight differences

Raise the average internal ratings-based (IRB) mortgage risk weight to narrow the difference between average mortgage risk weights for authorised deposit-taking institutions using IRB risk-weight models and those using standardised risk weights.

### Summary of NAB's position:

NAB does not agree with the Inquiry's view that an increase in mortgage risk weights is required. However if IRB mortgage risk weights are to be increased, NAB recommends that this be done in a way that: a) is consistent with the Basel framework; and, b) maintains risk sensitivity. Implementation of this recommendation must be consistent with any changes to capital standards which may emerge from the BCBS review, which is still in its early stages. For this reason, NAB recommends that any changes to mortgage risk weights not precede the outcome of the BCBS review.

### Principles:

NAB's view is that careful implementation is required if the policy objectives set out in Recommendation 2 are to be achieved. This should be done by adopting the six principles outlined below:

#### 1) **Consistency with the international capital agenda:**

NAB supports the FSI's view that Australia should take a cautious approach in developing requirements, follow international guidance and, where possible, avoid uniquely Australian positions.<sup>1</sup> Given the work that is currently underway by the BCBS on developing a revised standardised approach for credit risk and potential capital floors, NAB recommends that APRA not preempt these revisions by changing mortgage risk weights, until the BCBS's recommendations are finalised.

#### 2) **International harmonisation:** Any adjustments to mortgage risk weights that lead to differences versus minimum requirements under the Basel framework should be transparent, to allow for an internationally harmonised view.

3) **Retain risk sensitivity:** Implementation through a risk weight floor is inconsistent with the FSI's objective of ensuring that APRA maintains as much risk sensitivity in the capital framework as possible;<sup>2</sup> as it blunts incentives to price and manage risk appropriately.<sup>3</sup> As an example, a 20% risk weight floor would make around 75% of NAB's mortgage book largely unresponsive to risk-based pricing. Instead, should it be deemed necessary to increase risk weights, this should be done through a risk-based approach, by recalibration of model inputs based on loan characteristics (i.e. by increasing risk-weights on higher risk lending). A potential approach to achieve the target portfolio risk weight is to increase correlation factors in a risk sensitive manner (e.g. increasing with LVR<sup>4</sup>). This is similar to the approach used in New Zealand<sup>5</sup> and is supported by research.<sup>6</sup> This approach could be combined with a very low level risk-weight floor, to address the risk of model miscalibration or underestimation.

4) **Retain incentives for improved risk management capability:** Raising IRB risk weights too high (near the upper end of the range suggested by the FSI) will blunt the incentives for both advanced accreditation and improved risk management capability. NAB sees value in retaining the business case for investment in advanced models.<sup>7</sup> APRA is well placed to opine on an upper threshold.

5) **Focus on system resilience:** Increasing risk weights to the lower end of the 25-30% average portfolio range will improve system resilience. This is a policy decision which, whilst making the Australian banking system safer, will also increase costs, as the FSI noted.<sup>8</sup> NAB does not accept the competitive neutrality argument. We see evidence of robust competition currently and we do not agree that the current risk weight differential, when adjusted for like comparison, inhibits competition.<sup>9</sup>

1 Commonwealth of Australia (2014), "Financial System Inquiry Final Report", pages 21 and 60.

2 Ibid, page 66.

3 Ibid, pages 60 and 66.

4 This is consistent with recent research. See for example: M Read, C Stewart and G La Cava (2014), "Mortgage-related Financial Difficulties: Evidence from Australian Micro-level Data", RBA Discussion Paper, 2014-13. Research in New Zealand reached a similar conclusion, where loss rates on high LVR loans generally increased more during an economic downturn than loss rates on lower LVR loans. RBNZ (2013), "Consultation Paper: Review of bank capital adequacy requirements for housing loans (stage one)", RBNZ Ref #5151264, page 9.

5 RBNZ (2013), "Consultation Paper: Review of bank capital adequacy requirements for housing loans (stage one)", RBNZ Ref #5151264.

6 Empirical research lends some support to this approach, although the literature on this remains sparse. See for example Kupiec P (2006), "Basel II: A Case for Recalibration", FDIC and RBNZ (2013), "Consultation Paper: Review of bank capital adequacy requirements for housing loans (stage one)", RBNZ Ref #5151264, page 9. In addition, Basel mortgage correlation factors may be understated due to the higher incidence of fixed rate mortgages in the G10 population used in calibration. See for example, RBNZ (2013), page 7.

7 See: NAB (August 2014) "NAB's Response to the Financial Inquiry Interim Report."

8 Commonwealth of Australia (2014), "Financial System Inquiry Final Report", pages 53-57.

9 See: NAB (August 2014) "NAB's Response to the Financial Inquiry Interim Report."

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- 6) **Front book application:** 'Front book' application or grandfathering provision is recommended. The alternative, application to the whole book, is not required to address competition concerns and may create capacity problems with capital issuance. Under a front book approach, the whole book will be substantially re-weighted within a reasonable timeframe of approximately 5 years.

**Conclusion:**

NAB does not agree that an increase in mortgage risk weights is required. However, if IRB mortgage risk weights are to be increased, NAB recommends that this be done by risk-based changes to mortgage correlation factors. It should apply to the frontbook, be consistent with proposed Basel framework changes and be applied in a transparent manner to allow international harmonisation. A target at the lower-end of the 25-30% range is appropriate, to maintain the incentive for banks to improve their risk management capabilities.

NAB encourages APRA to continue to work with the industry in establishing standards that will further strengthen the resilience of the financial system by improving risk management capabilities. However, NAB cautions that it would be unwise for Australia to preempt the BCBS review of global capital standards, which is still in its early stages. NAB recommends that any changes to mortgage risk weights not precede the outcome of the BCBS review.

### **FSI Recommendation 3: Loss absorbing and recapitalisation capacity**

*Implement a framework for minimum loss absorbing and recapitalisation capacity in line with emerging international practice, sufficient to facilitate the orderly resolution of Australian authorised deposit-taking institutions and minimise taxpayer support.*

#### **Summary of NAB's position:**

NAB generally supports the loss absorbing capacity (LAC) proposals, but believes that a sufficiently long timeline for implementation is necessary to minimise the potential for market disruption caused by demand and supply imbalances and to allow sufficient time for new structural solutions to be developed.

#### **Establishing minimum LAC requirement:**

At the Group of Twenty (G20) Leaders' Summit in Brisbane in November 2014, the Financial Stability Board (FSB) formally recommended a total loss absorbing capacity (TLAC) framework. The aim is to finalise requirements by year end 2015 and to implement changes no earlier than 1 January 2019.<sup>8</sup> NAB supports the FSI's recommendation that Australian banks implement a framework in line with emerging international practice, noting that international guidelines are still in progress with long timelines for implementation.

In considering an appropriate calibration for Australian D-SIBs in comparison to the proposed Global Systemically Important Banks (G-SIB) requirements, NAB recommends that APRA assess past loss experience and that it notes the incremental improvements that have occurred in risk management frameworks since the GFC. Given Australian banks' relatively low loss experience, D-SIB requirements should be set at the lower end of the TLAC ranges proposed.

NAB also notes the reference to a leverage ratio minimum requirement as part of LAC recommendations and emphasises that the leverage ratio should be used as a back-stop measure only, so as not to void the merits of the risk-sensitive, risk-weighted asset (RWA) requirements.

#### **Structural solutions:**

As stated in prior submissions to the FSI, NAB does not agree with adopting a statutory bail-in regime for all senior bank creditors, as this would not be consistent with the goal of ensuring systemic stability. Likewise, NAB does not believe that LAC requirements should be solved with additional equity issuance.

To achieve the volume of LAC proposed by the FSB, NAB recognises that a structural solution will be required, whether this be: a) another tranche in the capital structure; b) senior unsecured debt that is contractually able to be bailed-in or; c) debt issued out of a holding company structure. In the interests of transparency, NAB advocates that LAC instruments be mandated within a contractual framework with full disclosure of associated terms and conditions, rather than on a statutory basis that is subject to interpretation. This approach will be less likely to present issues in the event of resolution, particularly for instruments governed under foreign law.

APRA should give consideration as to which investors are likely be buyers of any new LAC instruments, to ensure that there is sufficient capacity within the market to absorb global requirements and to better understand the implications this would have on Australian banks' funding profiles. Australian bank funding could be further skewed offshore, which would have implications for currency basis swap markets, liquidity stress tests and funding costs.

#### **Transparency:**

In the interests of full transparency and comparability, LAC requirements should be calculated on an internationally harmonised basis and be associated with a common disclosure template that is meaningful for investors, whilst being practical for compliance.

#### **Sufficiently long timelines for implementation:**

Given the potential volume of new LAC instruments required to meet minimum LAC thresholds, sufficiently long timelines for implementation are necessary, to ensure that demand balances supply. The funding challenge will be further compounded by an increase in RWA arising from regulatory change, such as the Fundamental Review of the Trading Book,<sup>9</sup> revised standardised approaches for credit risk and proposed capital floors, as well as changes to operational risk modelling.

Australian banks are active in international markets for capital and funding. At the same time, these markets will be seeing incremental demand for LAC instruments from G-SIBs. Consequently, APRA must ensure that there is an adequate transition period for implementing the LAC proposals, to prevent market instability. This will enable banks to raise LAC at acceptable pricing and allow time to avoid any unintended consequences. This is in line with recommendations proposed by the FSB.

<sup>8</sup> FSB (2014), "Adequacy of Loss-absorbing Capacity of Global Systemically Important Banks in Resolution, Consultative Document", page 9.

<sup>9</sup> BCBS (2014), "Fundamental Review of Trading Book: Outstanding Issues", released 20 February 2015.

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**Conclusion:**

NAB supports the principle that LAC plays a critical role for ensuring an orderly and credible resolution following the failure of a financial institution, as well as promoting trust and confidence in the financial system.

NAB also supports the notion that additional LAC will reduce the perception of an implicit government guarantee and the accompanying market distortions this creates, whilst reducing the burden on taxpayer funds in the event of a bank's failure.

Taking into consideration the international consultation that has already commenced on this issue with respect to G-SIBs, NAB recommends caution in determining LAC framework requirements, until such matters have been sufficiently resolved. Once resolved, long implementation timelines are required.

In determining its approach, APRA should: a) consider the relatively low historical loss experience of Australian banks; b) recognise the uplift in capital ratios that is achieved on an internationally harmonised basis; and, c) maintain the risk sensitivity of the calculation by including a leverage ratio requirement solely as a back-stop measure.

A structural solution, through either a new LAC instrument, contractual bail-in, or a holding company structure, is the most likely outcome. Statutory bail-in for senior unsecured debt and additional equity issuance are both unattractive options to address any shortfalls.

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#### **FSI Recommendation 4: Transparent reporting**

*Develop a reporting template for Australian ADI capital ratios that is transparent against the minimum Basel capital framework.*

#### **Summary of NAB's position:**

NAB agrees that there is value in developing an APRA-endorsed reporting template aligned with Basel direction, to disclose Australian bank capital ratios on an internationally harmonised basis. NAB acknowledges the complexity in achieving a fully comparable metric across jurisdictions and cautions against selective adjustments, which will have the effect of minimising the goals of transparency and comparability.

#### ***Template must align to international standards:***

Given the relative conservatism of APRA standards, a harmonised view is valuable in providing a like-for-like comparison of capital treatment on an international basis. Due to the inconsistent application of capital standards across multiple jurisdictions, alignment to the minimum Basel framework is a starting point for deriving this comparable measure. The effectiveness of this approach depends upon all jurisdictions adopting a harmonised template based on the Basel minimum framework, effectively removing adjustments resulting from national discretion.

Given that other jurisdictions are not currently pursuing this approach, NAB advises that care be taken in making adjustments back to a Basel minimum metric, as the end result will be another metric that is not fully comparable to international peer disclosures. To achieve comparability, a ratio aligned to international practice, rather than to the Basel minimum framework, would be more relevant and is preferred.

NAB highlights that the BCBS is currently working on improving comparability across the regulatory regimes (noting the BCBS's work programme for 2015 and 2016) and recommends that Australia follow BCBS's guidance in this area.

It is critical that the harmonised reporting template be unambiguous and useful for relevant stakeholders (APRA, BCBS, investors, etc.) so as to avoid introducing yet another capital measure into an already complex landscape of multiple constraints. APRA agreement and confirmation of the approach to arrive at an internationally harmonised metric would further enhance market confidence in this measure.

#### **Conclusion:**

NAB supports the development of a reporting template for Australian ADI capital ratios that is comparable to international practice, but recognises that implementation will be complex. To ensure that the harmonised reporting template is useful for stakeholders, NAB recommends undertaking a measured approach, endorsed by APRA. The reporting template should be developed by APRA through broad industry consultation and it should be aligned to the direction set by the BCBS.



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### **FSI Recommendation 7: Leverage ratio**

*Introduce a leverage ratio that acts as a backstop to ADIs' risk-weighted capital positions.*

#### **Summary of NAB's position:**

NAB agrees that the leverage ratio should remain a back-stop measure, given that it is not a risk-sensitive calculation, with the current prudential capital requirements remaining the binding constraint.

#### ***Leverage ratio is useful as a backstop to capital ratios:***

NAB agrees that the leverage ratio has merit as a capital adequacy measure, due to its simplicity and comparability across jurisdictions. However, its lack of risk sensitivity means that the leverage ratio should be a back-stop measure only. APRA should use the observation period through to 2017 to determine an appropriate level for this metric to achieve these objectives.

NAB agrees with the Inquiry's view that 3-5% appears a reasonable range, based on current settings.<sup>10</sup>

Risk sensitive capital requirements (for example, the current prudential capital requirements based in part on the internal ratings based approach for credit risk) should be maintained as the binding constraint, to more accurately align capital with risk and as an incentive to improve risk management capabilities.

The measure should be based on an internationally harmonised approach, subject to the comments highlighted for FSI Recommendation 4, to ensure a metric that is globally comparable.

#### **Conclusion:**

NAB supports the principle that a leverage ratio should remain a back-stop measure, given that it is not a risk-sensitive calculation. We recommend that APRA use the observation period through to 2017 to determine an appropriate level for this metric. NAB agrees that 3-5% appears to be a reasonable range and we recommend that the measure be based on an internationally harmonised approach.

# 3. Superannuation and Retirement Incomes

## FSI Recommendation 9: Objectives of the superannuation system

*Seek broad political agreement for, and enshrine in legislation, the objectives of the superannuation system and report publicly on how policy proposals are consistent with achieving these objectives over the long term.*

### Summary of NAB's position:

NAB supports the rationale of defining the objectives of the superannuation system, both in terms of its primary objective and a series of secondary objectives. This should lead to greater policy stability and provide a framework against which superannuation and related tax policy proposals can be assessed. If defined appropriately, it should also encourage consistency of policy settings between the accumulation and retirement phases.

### Establishment of the Superannuation Guarantee levy:

It is useful to review key developments since 1992, when the 36th Parliament consented to the Superannuation Guarantee Bills and to juxtapose these with the original and revised objectives of the system, to identify any inconsistencies.

On 2 April 1992, the then Labor Treasurer, the Hon John Dawkins, when introducing the Superannuation Guarantee, identified a number of key goals, including:<sup>11</sup>

- A major extension of superannuation coverage;
- An efficient method of encouraging employers to comply with their award obligations;
- A mechanism to permit a higher standard of living in retirement than if the pension were relied upon alone;
- Increased self-provision [to] enable future Commonwealth governments to improve the retirement conditions for those Australians who were unable to fund adequately their own retirement incomes; and,
- A mechanism to boost national savings.

Importantly, the new compulsory system was not designed with the sole aim of replacing the aged pension but rather, to augment the Government's support via the age pension and as a significant device in the pursuit of increased self-provision. This will become increasingly more important as the aged proportion of our population grows.

As noted in the 1994 National Action Plan for Australia: “[a] fundamental policy objective is to ensure that aged persons are able to maximise their income from private sources, while ensuring that dependence on Government income support is reduced.”<sup>12</sup>

Within this framework, the decision to maintain incentives encouraging employees to make additional contributions was of equal importance.

### Since then, support has been largely bi-partisan:

Successive governments and oppositions have respected the fundamentals of the 1992 reforms. Although there has been vigorous and productive debate on the regulatory and competition settings for the system, overall there has been a high degree of convergence between the major parties on most of these issues.

This was confirmed in July 2013 by the report to the Treasurer and Minister Assisting for Financial Services and Superannuation by the Charter Group, which comprised an independent Chair, regulators and representatives from the not-for-profit and for-profit sectors. This independent body identified the following high level objectives:<sup>13</sup>

- Provide an adequate level of pension;
- Relieve pressure on the age pension; and,
- Increase the national pool of savings.

The Charter Group noted that the system should allow retirees to achieve a standard of living in retirement above and beyond that which the age pension alone can achieve. The Charter Group issued a caution for critics not to judge the system prematurely, as it is still some years before it reaches maturity. In fact, as noted in the Charter Group's report, it will not be until the 2030s that retirees will have experienced the full benefit of a full working life in receipt of the nine per cent, and for the 12 per cent level of contributions, it will not be until the 2060s.<sup>14</sup>

<sup>11</sup> Superannuation Guarantee (Administration) Bill (1992), Second Reading Speech, the Hon John Dawkins, Treasurer.

<sup>12</sup> Australian Government Publishing Service (1994), Preface by the Hon Brian Howe, Acting Prime Minister.

<sup>13</sup> Charter Group (2013), “A Super Charter: Fewer Changes, Better Outcomes”, Commonwealth of Australia.

<sup>14</sup> Ibid



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### **Defining the objectives of the superannuation system today:**

To realise the aspirations of successive governments, NAB recommends adoption of a number of core and measurable objectives. The overarching summary of these core objectives would be “*improving living standards in retirement whilst reducing the cost of an ageing population to the Government (through the current and future taxpaying population)*”.

- 1) **Objective 1 – Boost the retirement incomes for all working Australians.** This objective can be expanded by stating the following specific targets:
  - A headline target replacement income of 70% of full time pre-retirement earnings; and,
  - The base of the headline target comprising, at least for a transitional period, the age pension and private earnings (the age pension continuing to act as the safety net to alleviate poverty).
- 2) **Objective 2 – Raise the level of self-sufficiency amongst Australia’s retirees.** This can be measured by setting target levels of sufficiency over the longer term comprising:
  - Increasing years of self-provision at a minimum of the age pension rate;
  - Ensuring that a significant majority of the superannuation population is saving to the level needed to fund the age pension over 10, 20 and 25 years; and,
  - Aspiring to a significant majority at system maturity privately reaching the headline target of 70% pre-retirement earnings for full retirement.<sup>15</sup>
- 3) **Objective 3 – Enhance the outcomes for those who qualify for a government pension.** This relates to the previous objectives. With increasing self-provision, Commonwealth expenditures on the safety net age pension could increase.
- 4) **Objective 4 – Boost the pool of national private savings.** Growth in superannuation savings, both in absolute terms and as a percentage of GDP, could be used to assess this objective.

- 5) **Objective 5 – Establish a regulatory framework that protects retirement savings.** Losses consequent to fraud and fund failure as a percentage of total retirement assets would be a useful measure of this objective.

- 6) **Objective 6 – To enhance competition for the management and investment of private savings.**

This can be measured by:

- A contestable market that evidences designs and options to suit a diverse range of needs and situations;
- Reductions in fees and charges;
- Enhanced engagement; and,
- Improved retirement income options.

NAB supports the Inquiry’s subsidiary objectives to clarify aims and outcomes, including smoothing of income over an individual’s lifetime, and the need for a system with efficiency and integrity. However, there is no recognition of key features built into the current system:

- *The provision of group insurance to superannuation members:* We believe this feature is of sufficient importance to warrant that it be defined in the overriding objectives of the superannuation system; and,
- *Choice of fund:* The superannuation system should continue to assist members to achieve their individual goals and make savings decisions that suit their particular personal circumstances.

#### **Conclusion:**

NAB recommends that the Government enshrine in law explicit and measurable objectives for the superannuation system, with the ultimate aims of: a) improving living standards in retirement; whilst also, b) reducing the cost to Government of an ageing population.

<sup>15</sup> If linked to revenue and equity measures, this objective would be capped at an absolute limit, similar to a ‘Reasonable Benefit Limit’ (RBL) subject to indexation at the annuity rate (for longevity management assuming a ‘safe withdrawal rate’ of 3-4% from a starting asset base).

### FSI Recommendation 10: Improving efficiency during accumulation

*Introduce a formal competitive process to allocate new default fund members to MySuper products, unless a review by 2020 concludes that the Stronger Super reforms have been effective in significantly improving competition and efficiency in the superannuation system.*

#### NAB's position:

NAB partially agrees with this recommendation. NAB supports the goal expressed by the Inquiry of enhancing efficiency in the superannuation system to improve net returns to members, as well as decoupling any additional filter or selection process for 'default superannuation' from the industrial relations system. NAB supports a Productivity Commission (PC) inquiry into system efficiency and competitiveness, but recommends that this occur from 2017 onwards. By that time, MySuper will have been in operation for three years and the transition of existing default products to MySuper will have been completed.

#### ***Stronger Super's role in driving improved efficiency:***

The Inquiry acknowledges that the efficiency of the superannuation system has improved over the past decade. However, it also concludes that greater benefits should have been achieved and cites a lack of strong price-based competition as a key reason that this has not occurred.<sup>16</sup>

The Inquiry highlights some of the factors driving higher costs and fees, including:

- **Supply-side issues:** Market fragmentation; costly asset management and active investment strategies; taxation and provision of insurance; and government policy changes.
- **Demand-side issues:** Weak member-driven competition due to lack of member interest; complexity; lack of comparability of fees and performance; and agency and structural problems.

NAB believes that many of these factors will be addressed as Stronger Super legislation initiatives are implemented. As such, NAB supports the Inquiry's view that no substantive changes be made until an assessment of the effectiveness of the Stronger Super reforms is made.<sup>17</sup>

Funds have only been able to offer MySuper products since 1 July 2013 and many funds are still absorbing one-off costs associated with the reforms. However, the Inquiry questions how effective these reforms will be. The Inquiry cites two key points in support of its view:<sup>18</sup>

- *The fees offered on MySuper products vary widely, with the difference between the highest and lowest fees of 136 basis points.*<sup>19</sup> This ignores the fact that much of the difference in fees lies in the tail. Removing the four most expensive MySuper products reduces the fee differential to less than 100 basis points. Furthermore, we anticipate a continued reduction in the distribution of MySuper fees, due to increased competition arising from the publication of fee levels across funds.
- *Much of the reduction in MySuper fees against comparable default options has been due largely to the Future of Financial Advice reforms prohibiting commission in MySuper products, rather than the introduction of MySuper.* It is true that some of the reduction in fees is from this source. But some of the reduction also flows from: a) the greater comparability MySuper affords between default options; and, b) the investment and operational efficiencies from consolidation into MySuper of the many previous default investment strategies in master trusts and other superannuation funds with legacy corporate arrangements. These latter trends are expected to continue to drive down MySuper fees.

Evidence that NAB presented in its response to the Inquiry's Interim Report indicated that:<sup>20</sup>

- Superannuation fees have reduced considerably over the last decade, despite the industry experiencing opposing forces;
- MySuper has already delivered reductions in fees and will continue to do so; and,
- Australian fees are not unreasonably high by international standards.

The Inquiry comments on the continued fragmentation of the Australian superannuation market. Market fragmentation is much less than it was a decade ago (ignoring the rise in Self-Managed Superannuation Funds [SMSFs]), driven by the introduction of choice of fund for the majority of Australians, requiring most superannuation funds to compete for members.

With MySuper now introduced, allowing greater comparability between default funds and together with the associated scale test, NAB anticipates continued fund consolidation. Indeed, fund consolidation will occur at a faster pace if some of the barriers to mergers are removed, including nomination of named default funds within the industrial relations system and restrictions on fund choice under some enterprise agreements. NAB welcomes the FSI's recommendation that these barriers to efficient operation of the system be removed.

<sup>16</sup> Commonwealth of Australia (2014), "Financial System Inquiry Final Report", pages xviii, 25, 89, 103.

<sup>17</sup> Ibid, pages xxiii, 101, 109, 111, 113, 182.

<sup>18</sup> Ibid, page 107.

<sup>19</sup> Chant West Super Fund Fee Survey (September 2014).

<sup>20</sup> See: NAB (August 2014), "NAB's Response to the Financial System Inquiry Interim Report", pages 13–15.

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A formal competitive process to allocate new default members to MySuper products has potential disadvantages, including:

- Removing the ability of an employer to take an active interest in fund selection and benefits tailored to the workforce.<sup>21</sup> This could lead to increased fees for employees of larger employers where administrative efficiencies have allowed discounts from the standard fee;
- Applying the new default system for new employees entering the workforce will take many years to have a material impact (if any);
- A perception that Government is endorsing the funds selected by the competitive process; and,
- The practicalities of the Government finding a mechanism to allocate new employees to a default fund and to inform the employer in a timely manner.

NAB supports the first alternative considered by the FSI – a system which involves abolishing the new Fair Work Commission (FWC) process for selecting default funds in awards and allows all MySuper products to be default options. If there is concern with existing APRA authorisation of a MySuper product not providing a sufficient quality check, this can be addressed by introducing additional checks and balances whereby APRA, whilst not approving the products specifically, imposes additional quality filters. For example, ensuring fees do not exceed a certain cap, or that asset allocations fall within a certain range.

The objections raised in the FSI Report to this alternative are outweighed by the following arguments:

- The PC report (2012) was issued before the initial number of MySuper products was known, with the eventual number being substantially lower than the estimates made;
- The vast majority of employers today have already chosen a default fund and there is less dislocation in maintaining the status quo than in introducing a new system;
- The number of additional accounts will be fewer than if the new Fair Work Act (FWA) default requirements are allowed to play out (see below); and,
- It remains illegal for a superannuation fund or provider to offer incentives for an employer to select a default superannuation fund. Those who raised this in submissions should be encouraged to provide evidence (in which case, action can be taken) rather than citing it as an impediment preventing employers selecting a default fund for their employees.

NAB recommends that changes to default fund allocation through the new FWA requirements be suspended permanently, otherwise, further inefficiencies in the superannuation system are likely.

The *Rafe Report* commissioned by the Financial Services Council (FSC) indicates that if the new FWA requirements apply:<sup>22</sup>

- At least 1.25 million employees will have their default contributions redirected to alternate superannuation arrangements, with the creation of 1.25 million additional superannuation accounts. The potential cost to impacted employees is \$185 million, with potential losses of at least \$100 million from asset buy/sell spreads and crystallisation of tax losses.
- Around 100,000 employers will be required to redirect superannuation contributions on behalf of some or all of their employees, with a potential cost in the region of \$30 million.
- A reduction in further competition, efficiency and innovation is likely, due to lack of incentive to compete, the sharing of infrastructure of many of the larger listed funds and the very high entry barriers for new funds.

#### **Conclusion:**

NAB recommends that the Government wait until the Stronger Super system is fully implemented in 2017, before the PC is asked to investigate and assess how a competitive process might work. In the meantime, NAB recommends that the existing Fair Work processes be permanently removed, to allow unimpeded competition between MySuper funds.

<sup>21</sup> Note: In New Zealand, this was overcome by allowing an employer to select any authorised KiwiSaver fund as its default fund for employees.

<sup>22</sup> Rafe Consulting (June 2014), "Impact of Changes To the Fair Work Act on the Australian Superannuation Sector, Employers and Their Employees", Report to FSC.

### FSI Recommendation 11: The retirement phase of superannuation

Require superannuation trustees to pre-select a comprehensive income product for members' retirement. The product would commence on the member's instruction, or the member may choose to take their benefits in another way. Impediments to product development should be removed.

#### Summary of NAB's position:

NAB agrees with the FSI's recommendation. We believe this is a change that is needed to:

- a) Encourage an income drawdown culture;
- b) Mitigate decision inertia for those overwhelmed by options; and,
- c) Promote product designs that include features that mitigate risks in income reliability, including longevity.

#### **Pre-selection will address many of the retirement phase issues identified:**

NAB supports and agrees with the Inquiry's view that:

*"Managing longevity risk through effective pooling in a CIPR [comprehensive income product for retirement] could significantly increase private incomes for many Australians in retirement and provide retirees with the peace of mind that their income will endure throughout retirement, while still allowing them to retain some flexibility to meet unexpected expenses."*<sup>23</sup>

Based on the December 2014 MLC Investment Trends Retirement Income Report,<sup>24</sup> this is a critical change that is needed to address the major concerns of many Australians:

- "Australians are feeling less confident, less informed and more worried about their retirement – and more likely to say they will ultimately depend on/rely on the age pension."
- "Outliving retirement savings is a big concern to an increasing proportion of those aged 40+, and particularly retirees."
- "Even more accumulators and pre-retirees now expect to struggle in retirement."

It is also a change that is needed to:

- Encourage an income drawdown culture;
- Mitigate decision inertia for those overwhelmed by options; and,
- Promote product designs that include features that mitigate risks in income reliability, including longevity.

Managing multiple financial objectives and risks in retirement is complex and is compounded by behavioural biases. NAB is an advocate of providing the right education and advice to help consumers make considered decisions so as to achieve 'self-reliance' in retirement.

NAB supports the Inquiry's recommendation that superannuation trustees be required to pre-select a CIPR for members and that the minimum features of the CIPR "include a regular and stable income stream, longevity risk management and flexibility."<sup>25</sup>

NAB's support for trustee pre-selection in the retirement phase does not prevent a member from choosing an alternative option. For this reason, pre-selection should not be seen as a 'mandated solution'.

We would add that there should also be a requirement that trustees contemplate the level of certainty of an income stream. This will reduce the risk of consumers buying products that do not match their needs and objectives.

We note that there are already a number of low cost retirement solutions available in the market today that reflect the prescribed requirements of a pre-selected CIPR. These include, but are not limited to, emerging 'guarantee' or 'protection' solutions. An example of a CIPR available today is MLC's *Protected Income for Life*.

NAB supports the Inquiry's view that this should be implemented with sufficient lead time to allow superannuation funds to design products or form partnerships with other providers, including life insurers.

In NAB's view, it is also important that there be a clear articulation of what constitutes an adequate retirement income. (See: NAB's response to Recommendation 9). There are many members in the current system who will not be self-sufficient for any period (or only for limited periods) making longevity features somewhat moot. Nevertheless, over the longer term, NAB recommends that the settings have regard to the risks of generating stable and reliable incomes for the majority of members in their retirement.

#### Conclusion:

NAB looks forward to playing a key role in improving outcomes for superannuation fund members and to helping Australia manage the challenges of an ageing population.

NAB recommends that the prescribed requirements for trustees in pre-selecting a comprehensive income product (or products) for retirement should contemplate the certainty of the income stream, so as to reduce the risk of consumers buying products that do not match their needs and objectives.

<sup>23</sup> Commonwealth of Australia (2014), "Financial System Inquiry Final Report", page 91.

<sup>24</sup> MLC (December 2014), "MLC Investment Trends Retirement Income Report".

<sup>25</sup> Commonwealth of Australia (2014), "Financial System Inquiry Final Report", page 117.

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### **FSI Recommendation 12: Choice of fund**

*Provide all employees with the ability to choose the fund into which their Superannuation Guarantee contributions are paid.*

#### **Summary of NAB's position:**

NAB supports this recommendation, which would see the removal of all regulatory impediments to individuals being able to exercise choice. This includes the removal of restrictions that may apply in the industrial relations system, such as those that currently exist in enterprise agreements and also potentially under modern awards.

#### ***Choice of fund is crucial to increase competition:***

NAB supports the intent of the Inquiry's recommendations as they relate to superannuation. It is appropriate to seek to lift the value of the superannuation system and retirement incomes, for the benefit of individuals and the economy overall.

The ability of employees to choose the fund into which their Superannuation Guarantee contributions are paid is an important step in creating a more competitive and dynamic superannuation industry.

It needs to be recognised that a system providing choice is more expensive than one without choice, because it creates additional administration requirements. However, the advent of clearing houses and the associated introduction of *SuperStream* means that the Australian superannuation system is now constructed to facilitate choice.

As a result of these developments, in NAB's view, extending choice to all employees should not increase overall costs significantly. Furthermore, to the extent that individuals are engaged and informed, choice of options facilitates outcomes that are more suitable to individual circumstances. Efficiency gains and lower costs alone do not automatically translate to more effective outcomes.

#### **Recommendation:**

NAB supports the removal of all regulatory impediments to employees being able to exercise choice of fund in deciding the fund into which their Superannuation Guarantee contributions are paid.



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## 4. Consumer Outcomes

### FSI Recommendation 21: Strengthen product issuer and distributor accountability

*Introduce a targeted and principles-based product design and distribution obligation.*

#### Summary of NAB's position:

NAB agrees with this recommendation. A targeted and principles-based approach to product design and distribution is already a core part of NAB's product development framework. When we identify issues in our business, we always work quickly to fix them. NAB would encourage regulators to set standards that are consistent with current industry best practice, including practices already used by NAB. These are outlined below.

#### Formalising industry best practice:

NAB supports the strengthening of consumer confidence and trust, whilst maintaining innovation and choice.

NAB believes that this is best achieved through a principles-based approach, focusing on appropriate market definition and product development (Recommendation 21 – Option 1), as distinct from introducing an individual appropriateness test or industry self-regulation. It should also recognise the framework that is currently in place to protect consumers via the *Financial Services Reform Act*, *National Consumer Protection Act* (NCCP) and the *Future of Financial Advice* (FoFA).

The obligation to identify target markets by considering a product's risk and return profile is aligned with NAB's product lifecycle and approval framework. NAB supports the need for a consistent and transparent decision making process and ongoing governance, to ensure that the right products are delivered to the right markets, at the right time.

The requirements within NAB's existing framework already support the recommendation's intent. For example, the NAB framework requires:

- Clearly defining target markets – by age, life stage and financial capability of consumers;
- Understanding the benefits and risks for existing and potential market segments;
- Ensuring that opportunities are driven by consumer needs and feedback; and,
- Establishing controls for distribution of the product, including periodic reviews as to whether the product continues to meet the needs of the target markets.

NAB agrees that the recommendation should not limit the products that could be developed and issued. The obligation should also acknowledge that product issuers may, through use of general advertisements, reach consumers outside the target market.

Finally, the obligations should recognise the impact of changing market standards and consumer expectations in any retrospective application.

#### Conclusion:

NAB agrees with this recommendation. A targeted and principles-based approach to product design and distribution is already a core part of NAB's product development framework. NAB would encourage regulators to set standards that are consistent with current industry best practice, including practices already used by NAB.

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**FSI Recommendation 22: Introduce product intervention power**

*Introduce a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment.*

**Summary of NAB's position:**

In principle, NAB agrees with this recommendation as an enhancement to the regulatory toolkit. However, if adopted, this recommendation should only be used as a last resort where there is a risk of significant detriment to a class of consumer. ASIC should be held to a high level of accountability when exercising these powers. We see the powers envisaged under Recommendation 22 as complementing those envisaged in Recommendations 21 and 23. Together, these three recommendations will strengthen the overall design, distribution and disclosure of products, however consideration also needs to be given to the impact that these powers will have on product innovation and competition.

***Accountability for product intervention power:***

NAB agrees that ASIC should be held to a high level of accountability for its use of product intervention powers, including being subject to a judicial review. In our view, the judicial review should be carried out by the Attorney – General or the responsible government department. This significant product intervention power should only be used as a last resort. Furthermore, in exercising this power, ASIC should be required to give careful consideration to the impact that product intervention would have on all investors in the affected products, not just the class of investors for whom ASIC sought the relief.

NAB looks forward to the public consultation noted in the recommendation, which is to occur prior to the drafting of the general policy describing the power. We expect to comment on how the power will be used and the outcomes from that use, for example, whether the outcomes would be detailed in a public report and whether firms would be subject to guidance, determination or enforcement.

We agree that the power does not and should not be seen to alleviate consumers from bearing responsibility for their financial decisions. The recommendation notes that clarity in respect of consumer responsibility will be provided. We look forward to reviewing this.

We agree with the implementation considerations noted in the recommendation, particularly that ASIC would engage with affected parties and consult with other regulators before exercising this power.

**Conclusion:**

In principle, NAB supports this recommendation. However, we suggest that it be implemented in a manner that ensures that there is a high level of accountability on ASIC, when exercising its product intervention power.

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**FSI Recommendation 23: Facilitate innovative disclosure**

*Remove regulatory impediments to innovative product disclosure and communication with consumers, and improve the way risk and fees are communicated to consumers.*

**Summary of NAB's position:**

NAB agrees with this recommendation. To enable consumers to be better engaged and informed, NAB supports the development of innovative approaches to product disclosure, including through the adoption of contemporary communication tools increasingly being used by consumers. This should include measures to assist consumers better understand the risk and return trade-off associated with most financial products.

**Use of ASIC pilot to trial innovative disclosure:**

NAB supports the current ASIC pilot being utilised as the vehicle to test these innovative approaches to disclosure, provided that there are feedback loops to facilitate earlier legislative support/intervention, if required.<sup>26</sup>

NAB agrees that, where appropriate, disclosure approaches should reflect consumer behaviour. The laws governing these disclosure approaches should be made with the benefit of insights delivered through the ASIC pilot and other relevant data points.

NAB supports a flexible approach to improving communication of risk and fees that allows tailoring for different classes of financial products. However, we also note that removing regulatory impediments to innovative product disclosure and communication should not lessen consumers' personal responsibility to understand information in relation to their financial decisions.

NAB has already taken steps to develop tools that leverage technology developments to meet consumer expectations. One example is the NAB online personal loan application form, which presents product information, such as rates and fees, in a more graphical and engaging interface. Other initiatives include the use of blogs and online videos, which are available to explain product features. There are also plans to develop other online tools that support consumers in their evaluation of the home buying decision. Laws governing these types of disclosures will support NAB in its efforts to innovate and build out a more customer centric approach to communicating with customers.

The short form product disclosure regime (which included allowing relevant information to be incorporated by reference) assisted, but it was not a complete answer to improving disclosure. Additional measures (such as consistently explained risk and return profiles, risk measures and graphics) have the potential to further improve the

effectiveness of disclosure about critical features of the financial product. In addition, before acquiring the financial product, consumers need to understand relevant risk and reward trade-offs.

**Conclusion:**

NAB supports this recommendation. Its implementation would be assisted by accelerating current initiatives that are already being adopted by the industry.



**FSI Recommendation 24: Align the interests of financial firms and consumers**

*Better align the interests of financial firms with those of consumers by raising industry standards, enhancing the power to ban individuals from management and ensuring remuneration structures in life insurance and stockbroking do not affect the quality of financial advice.*

**Summary of NAB's position:**

NAB agrees with raising standards of conduct and levels of professionalism.

Consumers need to be able to trust their adviser and have confidence that the advice is in the consumer's best interests. By raising industry standards of conduct and professionalism, consumers will gain greater confidence and receive better advice and outcomes.

NAB is participating in and is supportive of the Life Insurance and Advice Working Group (LIAWG) process.<sup>27</sup>

***Raising standards of conduct and levels of professionalism:***

It is NAB's view that raising standards of conduct and professionalism in the industry, so as to build confidence and trust in the financial system, is best achieved through a series of cultural changes. These include:

- Setting a higher minimum level of education, which is set and overseen by an independent education body;
- Placing greater emphasis on professional membership with compliant associations which have approved 'Codes of Ethics and Conduct';
- Mandating ongoing professional development, including specific ethics based units, overseen by professional associations; and,
- Introducing entry requirements for new advisors joining the industry that incorporate competency assessments, as well as a professional year.

The combination of these initiatives will raise professionalism and foster cultural change across the industry.

***Life insurance commission structures:***

NAB agrees that life insurance commission structures must change across the entire industry, including the removal of high upfront commissions, in order to reduce incentives for churning and improve the quality of advice. In this regard, NAB is supportive of the LIAWG process examining this issue, as well as efforts to define a sustainable commission model based upon an industry-wide level commission structure and a capped service fee. Implementation should be mandatory and should be achieved either by legislation, ASIC regulations or an effective mandatory self-regulatory regime, as appropriate.

Through this process of industry transformation, NAB is highly supportive of measures to ensure that more advisors enter the industry and that existing advisors and licensees can adjust their business models confidently and effectively.

We strongly believe that quality advice and advisors are at the heart of Australia's wealth system.

**Conclusion:**

NAB supports the need to raise standards of conduct and levels of professionalism. As NAB has demonstrated, we always act quickly to fix issues in our business, as soon as they are identified. NAB also supports the industry wide mandatory removal of high upfront commissions for life insurance, in order to reduce incentives for churning and improve the quality of advice. Changes to achieve these outcomes should occur over an appropriate transition period.

<sup>27</sup> ASIC released a *Review of Retail Life Insurance Advice* in October 2014. Following this, the Association of Financial Advisers (AFA) and the FSC established a Life Insurance and Advice Working Group (LIAWG) headed by an Independent Chairman, John Trowbridge. Its purpose is to review ASIC's report and present durable solutions to the issues raised.

## 5. Significant Matters

### FSI Recommendation 36: Corporate administration and bankruptcy

*Consult on possible amendments to the external administration regime to provide additional flexibility for businesses in financial difficulty.*

#### Summary of NAB's position:

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.

#### ***Australian regime already supports business turnarounds 'out-of-Court':***

The FSI Final Report does not provide extensive analysis on the current Australian corporate administration and bankruptcy regime. However it does canvass a number of issues received by submissions. NAB believes that these issues warrant discussion.

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.

#### ***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.<sup>28</sup> The ABI was concerned that Chapter 11 was 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 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.

#### ***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).

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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.

***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.

***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.

**Conclusion:**

NAB does not support the implementation of a 'Chapter 11' regime in Australia. Instead, we believe that considerable improvements can be achieved by amending Australia's existing VA and bankruptcy regime, as outlined above.

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### **FSI Recommendation 37: Superannuation member engagement**

*Publish retirement income projections on member statements from defined contribution superannuation schemes using ASIC regulatory guidance. Facilitate access to consolidated superannuation information from the Australian Taxation Office to use with ASIC's and superannuation funds' retirement income projection calculators.*

#### **Summary of NAB's position:**

NAB supports this recommendation. NAB supports the inclusion of income based projections as well as lump sum estimates, but we recommend that the framework that underpins these projections be a balance of principles-based and rules-based approaches.

#### ***Use of projections to lift member engagement:***

Current industry practices mean that members are generally provided only with the account balance available on their statements. This creates an 'investment' mindset, rather than an 'income' mindset. NAB supports shifting the focus away from solely accumulated account balances, to one which also focuses on retirement outcomes.

The member statement is an important 'moment of truth' for members. It is also a unique opportunity to educate and inform members, not only about the historical performance of their superannuation (rear view), but also about their preparedness for retirement (forward view). In this sense, the member statement becomes a more empowering document, by giving members the motivation and means to act.

NAB supports the inclusion of income based projections as well as lump sum projections, but we recommend that the framework that underpins these projections be a balance of principles-based and rules-based approaches. In NAB's experience, the introduction of 'prescriptive only' rules in relation to member statements can have unintended consequences, such as the need to provide extensive disclaimers. In addition, for investment platforms (e.g. wraps), the diversity of assets and member-directed investments could make income projections difficult to calculate or misleading, depending upon the framework prescribed.

For these reasons, we believe that a combination of 'principles-based' and 'rules-based' approaches is required.

#### **Conclusion:**

NAB supports the inclusion of income based projections as well as lump sum estimates, but recommends that the framework that underpins these projections be a balance of principles based and rules based approaches.

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## 6. Concluding Remarks

NAB appreciates having had the opportunity to respond to the FSI's recommendations and we believe that we are well positioned to meet the regulatory changes that will follow.

We look forward to continuing to work with Government and regulators during the implementation phase, to ensure that Australia continues to enjoy the benefits of a world class financial system that is efficient, resilient and fair.

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