ROYAL COMMISSION INTO MISCONDUCT IN THE BANKING, SUPERANNUATION AND FINANCIAL SERVICES INDUSTRY

THIRD ROUND OF PUBLIC HEARINGS: LOANS TO SMALL AND MEDIUM ENTERPRISES

SUBMISSION OF NATIONAL AUSTRALIA BANK LIMITED (NAB) - QUESTIONS ARISING FROM THE THIRD ROUND OF PUBLIC HEARINGS

A. INTRODUCTION

1 National Australia Bank Limited (**NAB**) provides the following submission in response to Senior Counsel Assisting's invitation to respond to the general questions arising from the case studies considered in the third round of public hearings concerning loans to small and medium enterprises.

B. TOPIC 1 – RESPONSIBLE LENDING

General questions arising from the three case studies (ANZ, Westpac and Bank of Queensland)

2 **Question 1:** *How much responsibility do the borrower and lender bear in assessing the cash flow forecasts and other factors when deciding whether to enter into the loan contract?*

3 **NAB's response:** In the context of lending to small and medium sized businesses, the borrower is responsible for preparing and submitting cashflow forecasts and other financial information in support of the loan application. The borrower may prepare and provide this information with the assistance of an accountant, lawyer or other third-party advisor. But it is a matter for the borrower as to whether (and to what extent) it uses a third-party advisor to assist with the preparation and/or review of such information.

4 In NAB's submission, and consistently with the obligations under the Code of Banking Practice (**Code**),[1] the lender should make an independent assessment of the cashflow forecasts and other financial information submitted by the borrower. The lender's independent assessment should include consideration of whether forecasts are sensible in view of available, relevant information (including the past performance of the business or the lender's knowledge of local economic conditions), and application of sensitivities (such as a decrease in sales or an increase in expenses) to test the resilience of the business and its ability to meet repayment obligations. Without an independent assessment of the cashflow forecasts and other financial information provided by the borrower, the lender cannot make an adequate assessment of the risk involved in the proposed loan.

5 **Question 2:** *What is the content (and outer limit) of a bank's duty to act as a prudent and diligent banker in assessing a business loan application? Should the content (and outer limit) of the duty be codified?*

6 **NAB's response:** The duty to act as a diligent and prudent banker is set out in the Code.[2] NAB is contractually bound by the obligations under the Code. Clause 27 of the Code expresses the duty to act as a diligent and prudent banker in the following terms:

> *27. Provision of credit*
>
> *Before **we** offer, give **you** or increase an existing, credit facility, **we** will exercise the care and skill of a diligent and prudent banker in selecting and applying **our** credit assessment methods and in forming **our** opinion about **your** ability to repay the credit facility.* (emphasis in original)

7 The content and limits of the duty have been considered in a number of judicial decisions.[3] The duty to exercise the care and skill of a diligent and prudent banker is an objective, contractual standard. The duty is owed to both borrowers and

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[1] Exhibit 3.144, WIT.0001.0048.0001, Statement of Anna Maria Bligh dated 17 May 2018, with exhibits tendered as exhibits 3.144.1-3.144.58 (**Bligh Statement**). Bligh Statement, tab 2, ABA.001.007.1128 at .0022 (clause 27).
[2] Bligh Statement, tab 2, ABA.001.007.1128 at .0022 (clause 27).
[3] *Doggett v Commonwealth Bank of Australia* (2015) 47 VR 302; *National Australia Bank Limited v Smith* [2014] NSWSC 1605; *Westpac Banking Corporation v Haynes; Haynes v St George Bank A Division of Westpac Banking Corporation* [2017] SASC 23 (***Westpac Banking Corporation v Haynes***); *Bank of Queensland v Edwards* [2017] QSC 191.

guarantors.[4] It requires a standard of conduct other than mere 'accepted' practice, if what is 'accepted' practice is not able to be described as prudent practice.[5]

8 The duty imposes a single obligation with two components.[6] The banker must exercise the care and skill of a diligent and prudent banker '*in selecting and applying [its] credit assessment methods* ***and*** *in forming [its] opinion about [the customer's] ability to repay [the loan]'*. The two limbs of the duty are read as a compound proposition which serves to regulate the manner of assessment and ultimate formulation of the banker's opinion as to the borrower's capacity to repay a loan.[7]

9 However, the duty does not *require* a banker to form an opinion that a borrower will be able to repay the loan.[8] Rather, the duty requires care in the formation of an opinion actually formed regarding the borrower's capacity to repay the loan having regard to, *inter alia*, the borrower's ability in the event of default to call upon additional financial resources not immediately available to the borrower.[9]

10 The duty to act as a diligent and prudent banker is expressed somewhat differently in the draft revised Code, which was first submitted to the Australian Securities and Investments Commission (**ASIC**) for approval on 19 December 2017, and then amended on 23 April 2018 after consultation with ASIC (**Proposed Code**).[10] Chapter 17 of the Proposed Code relevantly provides:

> ***Chapter 17 A responsible approach to lending***
>
> ***Lending to individuals and small businesses***
>
> *49. If we are considering providing you with a new loan, or an increase in a loan limit, we will exercise the care and skill of a diligent and prudent banker.*
>
> ...

[4] *Doggett v Commonwealth Bank of Australia* (2015) 47 VR 302 at [139], [147] per McLeish JA (Whelan JA and Garde AJA agreeing).
[5] *National Australia Bank Limited v Smith* [2014] NSWSC 1605 at [193] per Slattery J.
[6] *Westpac Banking Corporation v Haynes* [2017] SASC 23 at [62] per Nicholson J.
[7] Ibid (emphasis in original).
[8] *Doggett v Commonwealth Bank of Australia* (2015) 47 VR 302 at [163] per McLeish JA (Whelan JA and Garde AJA agreeing at [8], [218]).
[9] Ibid.
[10] Bligh statement at [27]. Bligh Statement, tab 4 (the Proposed Code with tracking changes dated 23 April 2018), ABA.001.008.0434 at .0451 and tab 5 (a clean version of the Proposed Code dated 7 May 2018), ABA.002.001.0211 at .0228.

> *51. If you are a small business, when assessing whether you can repay the loan we will do so by considering the appropriate circumstances reasonably known to us about:*
>
> *a) your financial position; or*
>
> *b) your account conduct.*
>
> *Where reasonable to do so, we may rely on the resources of third parties available to you, provided that the third party has a connection to you. For example where the third party is a related entity of yours (including but not limited to your directors, shareholders, trustees, beneficiaries or related body corporates), or is a partner, joint venturer, or guarantor of yours.*

11 While differently expressed, the content and limits of the duty to act as a diligent and prudent banker have not materially changed under the Proposed Code. Consistently with the existing case law, clauses 49 and 51 expressly clarify that the duty applies in the small business context to a banker's assessment of whether the borrower (or guarantor) can repay the loan. The clauses also clarify that in making that assessment, a banker will consider the borrower's financial position and account conduct (i.e. a borrower's conduct in relation to other banking accounts / arrangements), including by having regard to (where it is appropriate to do so) the resources of third parties available to the borrower.

12 The duty to act as a diligent and prudent banker provides protection for both banks and their customers (including guarantors), including by reducing enforcement risks for banks and ensuring that due care and skill are exercised in offering customers facilities. However, and self-evidently, the duty does not extend to imposing an obligation on the bank to advise the customer or to act in what it might consider to be the best interests of the customer. Rather, the duty extends to ensuring that, based on the information available to it, the bank acts diligently and prudently in assessing the customer's ability to repay the loan. The limits of the duty reflect the reality that the customer retains ultimate responsibility for satisfying itself (including through the use of legal and financial advisors) that it is in a position to meet its obligations, and that the customer is in a better position than the bank to make that assessment.

13 As to codification, NAB does not consider that the duty to act as a diligent and prudent banker should be codified in legislation. The nature of the duty does not lend itself to prescriptive requirements or a "one-size fits all" approach. The requirements of the duty are case-specific and depend on a range of factors, including the nature of the borrower's business and the borrowing proposal.

14 Further, imposing prescriptive statutory requirements may inhibit access to credit. Codification will also remove the greater flexibility offered by the Code. As the recent amendments demonstrate, the obligations imposed by the Code can be more readily clarified and/or refined in response to changing circumstances.

15 **Question 3:** *Should any of the provisions of the National Credit Act which apply to consumer credit contracts also apply to credit contracts with small and medium sized businesses? If so, why and to which small and medium business customers? If not, why not?*

16 **NAB's response:** NAB does not support extending the application of any of the *National Consumer Credit Protection Act 2009* (Cth) (**NCCPA**) provisions (including the National Credit Code which appears at Schedule 1 to the NCCPA), which currently apply to consumer credit contracts, to credit contracts with small and medium businesses.

17 In that respect, NAB agrees with and endorses the position taken by Senior Counsel Assisting,[11] Phil Khoury[12] and the Australian Banking Association (**ABA**)[13] that the prescriptive requirements of the NCCPA should not be extended to small businesses and/or be imported into the Code. The reasons for this include that the NCCPA places greater emphasis on evidencing past earnings as a means of servicing, whereas most business credit is based upon future forecast earnings. It is also difficult to see how the relevant consumer credit contract standards could be implemented in relation to cashflow forecasting (particularly if the forecasts relate to ventures that remain speculative because certain events are yet to happen). If the emphasis on past performance is extended to the small and medium business sphere,

[11] Senior Counsel Assisting Closing Address T3028.40-44 and T3034.4-12.
[12] Exhibit 3.4, WIT.0001.0033.0001, Statement of Philip George Khoury dated 18 May 2018, with exhibits tendered as exhibits 3.4.1-3.4.4 at [21].
[13] Bligh Statement at [64].

NAB considers that it would lead to a potentially significant limitation in the provision of credit to such businesses.

C. TOPIC 2 – GUARANTEES BY THIRD PARTIES

Westpac Flanagan Case Study

18 **Question 1:** *Is there any inadequacy or gap in the established legal protections available to people in the position of guarantors? If so, what is it? If not, would the protections apply in the case of Ms Flanagan?*

19 **NAB's response:** There are a number of established legal protections for guarantors. For example, equity provides protection for volunteer guarantors in cases where the procurement and/or enforcement of a guarantee is unconscionable, including in situations where:

a. a credit provider takes advantage of a special disadvantage on the part of the guarantor;[14] and

b. a credit provider is on notice of a relationship of trust and confidence between the guarantor and the principal debtor and fails to adequately explain the nature of the transaction to a guarantor.[15]

20 Further, there are statutory protections available to guarantors, for example, in the *Australian Securities and Investments Commission Act 2001* (Cth) (***ASIC Act***) and the *Contracts Review Act 1980* (NSW) (***Contracts Review Act***). The *ASIC Act* prohibits unconscionable conduct within the meaning of the unwritten law[16] and in connection with supply or acquisition of financial services.[17] The *Contracts Review Act* provides relief against "unjust" contracts or provisions.[18]

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[14] *Commercial Bank of Australia Ltd v Amadio* (1983) 151 CLR 447.
[15] *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395. See also *Kranz v National Australia Bank Ltd* (2003) 8 VR 310.
[16] ASIC Act, s 12CA.
[17] ASIC Act, s 12CB. Section 12CB is not limited by the unwritten law of the States and Territories relating to unconscionable conduct: s 12CB(4)(a). Further, in determining whether conduct is unconscionable within the meaning of s 12CB of the ASIC Act, the Court must have regard to a range of factors, including (*inter alia*) the terms of any applicable industry code, such as the Code: s 12CC(1)(h).
[18] "Unjust" includes contracts or provisions which are "unconscionable, harsh or oppressive": s 4(1). The criteria for determining whether a contract or provision is "unjust" are provided for in s 9(1). The protections have been successfully invoked by guarantors: see e.g. *Fast Fix Loans Pty Ltd v Samardzic* [2011] NSWCA 260.

21 Clause 31 of the Code also provides extensive protections for guarantors. For example, it requires signatory banks (which includes NAB) to give guarantors prominent notice that:

a. the guarantor should seek independent legal and financial advice on the effect of the guarantee (cl 31.4(a)(i));

b. the guarantor can refuse to enter into the guarantee (cl 31.4(a)(ii));

c. there are financial risks involved (cl 31.4(a)(iii));

d. the guarantor has a right to limit their liability in accordance with the Code and as allowed by law (cl 31.4(a)(iv)); and

e. the guarantor can request information about the transaction or facility to be guaranteed (cl 31.4(a)(v)).

22 Clause 31 also requires signatory banks to provide specified information to the guarantor about the borrower and the facility prior to taking a guarantee from the guarantor (cl 31.4(b)).

23 The Proposed Code enhances such protections (see Part 7 of the Proposed Code), including by extending the period which the guarantor must be given to consider information before a guarantee can be taken from them from one day to three days.

24 The Proposed Code also provides (by Chapter 14, clauses 38 to 41)[19] that the signatory banks are committed to taking extra care with all vulnerable customers and guarantors, including those experiencing age-related impairment, cognitive impairment, elder abuse, family or domestic violence, financial abuse, mental illness, serious illness, or any other personal, or financial, circumstance causing significant detriment. This is an enhancement of clause 7 of the Code, which states that a signatory bank recognises the needs of older persons and customers with a disability to have access to transaction services, and will take reasonable measures to enhance their access to those services.

[19] Clause 38 refers to vulnerable "customers", whereas clauses 39 to 41 use the language of "you" and "your". By clause 1, these words are defined to include guarantors and prospective guarantors.

25 Having regard to the above, NAB does not consider there to be any inadequacy or gap in the legal protections available to guarantors. Rather, the challenge for lenders is how best to give effect to existing legal obligations.

26 NAB is not in a position to make submissions specifically in relation to Ms Flanagan.

27 **Question 2:** *(i) Is it desirable to take steps to increase the likelihood that a third-party guarantor of business borrowings will be properly advised and make an informed decision before entering into a guarantee? If so, what might those steps be?*
(ii) What difficulties will be created for banks or borrowers by steps that require more information to be provided to legal or financial advisors of a guarantor before the guarantee is signed?

28 **NAB's response:** As to (i), NAB does not consider that any additional steps concerning the procurement of third-party guarantees should be mandated; however any such steps, if taken, should be directed to ensuring that the guarantor fully understands the nature and risks of the transaction and is entering into the guarantee freely.

29 NAB does not consider that the best way to achieve this is by focusing on the provision of additional legal advice to guarantors or the provision of further financial information to guarantors. Legal advice provided to guarantors is properly directed to the legal effect of the guarantee documents. A lawyer is not qualified to, and should not be expected to, undertake a broader (non-legal) assessment of the particular risks arising from entry into the guarantee, including in relation to the profitability or performance of the underlying business.

30 As to the provision of financial information, consistently with the obligations contained in the Proposed Code, signatory banks are committed to providing guarantors with a range of information concerning the current financial situation of the debtor.[20] It is NAB's position that it is properly the responsibility of the guarantor (and not the bank) to determine whether to use that information to obtain

[20] Proposed Code, clause 99 (Bligh statement, tab 4, ABA.001.008.0434 at .0458 and tab 5, ABA.002.001.0211 at .0235).

independent financial advice about the risks arising from the nature and performance of the underlying business and, correlatively, the guarantee.

31 Moreover, imposing additional requirements (in particular, increasing the scope of the legal advice to be provided, or requiring the guarantor to obtain independent financial advice) will increase the burden to customers and lenders associated with guarantees in terms of cost, time involved, and administration. Given the increased burden, NAB submits that the Commission should only make findings contemplating such steps if there were evidence before it that any additional requirements would be likely to operate in a materially protective way and there was a net benefit from such requirements. There is no such evidence before the Commission. In NAB's submission, in circumstances where guarantors are often parents or spouses who are motivated by love and the desire to assist their loved one, more advice (whether legal or financial) is not likely to alter or influence the prospective guarantor's decision-making.[21] Put another way, the imposition of additional requirements assumes, incorrectly, that decision-making that is often emotionally-driven will be influenced by additional advice or information. Such an assumption is not founded upon evidence before the Commission, and is contrary to NAB's day-to-day experience with guarantors. For these reasons, the imposition of additional requirements is not the right approach to take.

32 Rather than focusing on legal advice or the provision of further financial information, in NAB's view, the better approach involves the bank undertaking a risk-based assessment of the suitability of the guarantor before any meeting with a representative of the bank. The risk-based assessment should seek to identify "red flags" based on a range of factors including (but not limited to): the nature of the relationship between the guarantor and the borrower; the guarantor's financial circumstances and level of sophistication; and the nature of the underlying business and loan facility.

33 Further, depending on the outcome of that risk-based assessment, it may be appropriate for a separate representative of the bank (i.e. someone other than the

[21] Mrs Flanagan's evidence was "*I would have signed anything… if you can't help your children who can you help…"*: Flanagan XXN T2046.40-45.

banker with primary responsibility for the borrower) to meet with the guarantor in order to assess, from the bank's perspective, whether the guarantor understands the transaction and is freely entering into it.

34 In relation to (ii), to a large extent, the answer depends on what is meant by "more information". In NAB's view, the information provided to guarantors pursuant to clause 99 of the Proposed Code is more than adequate for the purposes of providing the guarantor's legal and financial advisor(s) with material to appropriately advise their client.

D. TOPIC 3 – CONSUMER REDRESS SYSTEMS

35 **Question 1:** *If a business loan is determined to have been affected by maladministration, should the financial services provider be permitted to require the loan to be repaid within a timeframe shorter than the remaining term of the loan in circumstances where the borrower is willing and able to meet the repayment schedule under the loan?*

36 **NAB's response:** The answer to this question depends on the type and nature of the maladministration and, therefore, can only be determined on a case-by-case basis.

E. TOPIC 4 – BANKWEST BUSINESS LENDING BOOK

37 **Question 1:** *How, if at all, are banks to deal with circumstances in which, for reasons extraneous to the conduct of the borrower, the bank no longer wishes to fund a particular business or industry? That is, what is the bank to do if, for example, the market has changed such that its security is no longer adequate? What are the obligations, if any, on a bank in those circumstances?*

38 **NAB's response:** In NAB's case, the answer to this question is determined by reference to its standard form lending contracts (as revised in October 2017). In relation to both small and medium businesses, if NAB decides it no longer wishes to fund a particular business or industry, NAB would continue to comply with its contractual obligations. Under its revised standard form lending contracts, NAB cannot unilaterally decide to cease funding due to changes in market conditions (in circumstances where there are no substantive adverse market impacts on the

business itself).[22] When the contract term comes to an end, NAB could then consider its options (which would include deciding not to renew the contract on at least 90 days' written notice).[23] In NAB's submission, this is a fair position. Lenders should be able to form a view about particular industries in the context of an evolving economy, and make decisions about, for example, whether the risk profile of a particular industry has changed in such a way that warrants a change in the lender's approach to lending.

39 If (in contrast to the above scenario) substantive adverse market impacts are seen in the context of a particular business (for example, if a change in a particular industry materially impacts the values of the business), NAB's options differ depending on the size of the business and type of lending product. With the exception of "specialised facilities" (i.e. where the covenants are so integral to the operation of the product that NAB would be unable to continue to provide those products without them), NAB has removed non-monetary financial indicator covenants as triggers for default and enforcement for small business borrowers with less than $3 million in aggregated lending.[24] However, in relation to medium business borrowers (being borrowers with more than $3 million in aggregated lending), NAB has the contractual capacity to rely on non-monetary financial indicator covenants as triggers for default and enforcement. This is not inappropriate given that breaches of non-monetary covenants are often indicators of impending financial difficulties,[25] and (self-evidently) larger, more complex lending facilities carry greater risks for lenders.[26]

40 However, whether in any given case NAB will take the step of placing a loan into default will depend on the unique circumstances of that case. NAB's policies and procedures relevant to assessing and managing loans where there is a breach of non-monetary covenants are addressed in the evidence of Mr McNaughton.[27] As Mr McNaughton's evidence makes clear, only a small proportion of customers who are

[22] Exhibit 3.146, WIT.0001.0050.0001, Statement of Sean Leo Cash dated 16 May 2018 with exhibits tendered as exhibit 3.146.1-3.146.188 (**Cash Statement**), tab 2, NAB.005.184.1457 at .1472.
[23] Cash Statement, tab 2, NAB.005.184.1457 at .1461.
[24] Cash Statement at [20].
[25] Exhibit 3.140, WIT.0001.0046.0001, Statement of Ross Hugh McNaughton dated 22 May 2018 (as amended), with exhibits tendered as exhibits 3.140.1-3.140.144 (**McNaughton Statement**), tab 5, NAB.005.191.0016 at .0017.
[26] Cash Statement, tab 104, NAB.005.207.0785 and tab 188, NAB.005.288.0001.
[27] McNaughton Statement at [12].

referred to Strategic Business Services (**SBS**) for management (the team within NAB that deals with stressed or defaulted business loans) are referred for breaches of non-monetary covenants. The vast majority of customers referred to SBS for management are referred due to a breach of a monetary covenant.[28]

41 It should be emphasised that where a change in a particular industry or market is impacting a customer's business, it is NAB's responsibility (and to the customer's benefit) to actively engage with the customer and ensure that appropriate strategies are put in place to assist the customer to continue to meet their obligations under their loan contract.

42 **Question 2:** *Is there any reason why valuations or investigative accountants' reports ought not be provided to customers in circumstances in which the reports have been paid for by the customer and the bank wishes to take reliance, at least in part, on such reports? Is there any reason why such transparency obligations should be limited by the size of the loan or limited to providing only parts of the report?*

43 **NAB's response:** The answer will depend on the circumstances. NAB considers that a lender should be entitled to decide not to provide valuations where provision of the report may impact on recovery, for example, where the customer requests the valuation of the asset, prior to the sale of that asset. After the sale of the asset, NAB would provide a copy of the valuation if requested, subject to any confidentiality obligations in the valuation report. In respect to investigative accountants' reports, certain sections of the report containing sensitive information may not be provided to the customer. This would primarily include security assessments which need to be kept confidential in the event a sales process is required.

44 That is consistent with the position under NAB's current standard form lending contracts: customers who are not in default may request a copy of any non-residential property valuation report, NAB's instructions to the valuer and a full copy of the valuation report in respect of any security, or any property the subject of any security.[29]

[28] McNaughton Statement at [20].
[29] Cash Statement, tab 2, Business Lending General Terms, NAB.005.184.1457 at .1470 - .1471.

45 **Question 3:** *Is it appropriate for a bank to take enforcement action when no monetary defaults have occurred and the bank can rely only on non-monetary defaults? Why or why not? Should there be some additional protection for borrowers in these circumstances and ought the bank be obliged to explain such matters?*

46 **NAB's response:** NAB considers that, consistently with the approach adopted in its revised standard form lending contracts, it is appropriate for banks to take enforcement action in response to non-monetary defaults only in certain limited circumstances.

47 NAB, along with other members of the ABA, have removed material adverse change clauses from its standard form business lending contracts and replaced them with specific events of default (known as "Adverse Events"). NAB is only entitled to take action if the Adverse Event is reasonably likely to have a significant negative impact on the customer's ability to repay the amounts owing or NAB's ability to recover amounts owing from any security.[30]

48 As noted in paragraph 39 above, NAB has also removed financial indicator covenants as triggers for default and enforcement for small business borrowers with less than $3 million in aggregate lending (with the exception described above for small businesses with "specialised facilities").[31]

49 If NAB is to continue to support the fast-growing service sector of the economy and, in particular, continue its increasing support for businesses with intangible assets, it must retain the ability to rely on financial indicator covenants for particular industries, products and customers.

50 NAB considers that credit will be unduly restricted if further limitations are placed on its ability to rely on financial indicator covenants in appropriate cases. In the case of businesses with more complicated business structures and larger borrowing facilities, there is typically greater reliance on complex and diverse cashflows to provide capacity for the borrower to meet its commitments. The use of financial indicator covenants is necessary to monitor the performance of the business,

[30] Cash Statement at [20].
[31] Cash Statement at [20].

including by reference to the ongoing sustainability of these cashflows, which provides a level of protection to both the borrower and the bank. [32]

51 **Question 4:** *Is there a disconnection between what the banks are saying in their advertising, their annual reports, their other public documents and their conduct? If there is a disconnection between them, what, if anything follows from that?*

52 **NAB's response:** NAB does not consider there to be any relevant disconnect between its public statements (whether by way of advertising, annual reports or other public documents) and its conduct.

53 NAB does not take the privilege of providing financial services to its customers lightly. NAB recognises, and has publicly acknowledged, there are times when it has fallen short of customers' expectations and made mistakes. While always regrettable, instances of misconduct or failure to meet legal and regulatory standards are a risk in conducting a financial services business of NAB's size and complexity. That, however, does not make such instances acceptable.

54 NAB takes accountability to customers very seriously, and in recent years has worked hard to improve in this area. NAB is committed to ensuring its approach to identifying, remedying and preventing risk events (including operational and conduct risk) is robust, and regularly reviewed, to ensure compliance with its legal and regulatory obligations and/or industry standards. In addition, NAB has made culture and ethics a key emphasis in recent years, including through NAB's purpose and values.[33]

F. TOPIC 5 – POWER AND COMMUNICATION

Bank of Melbourne Wallis Case Study

55 **Question 1:** *Should the sales culture for small business reflect that of consumer lending in that business bankers are discouraged from focusing primarily on financial incentives in their key performance indicators?*

[32] Cash Statement, at [42], tab 188 (NAB.005.288.0001). This is also consistent with the position of the ABA more generally in respect of more complex businesses with larger borrowing facilities as more recently expressed – see for example, Bligh Statement, [104(c)].

[33] NAB's submission in response to questions arising from the second round of hearings dated 7 May 2018 at [78], and which referred to Exhibit 2.178, WIT.001.0022.0001, Statement of Andrew Paul Hagger dated 5 April 2018 at [75].

56 **NAB's response:** The sales culture in small business lending must strike the appropriate balance between business outcomes (including revenue and volume growth) and behavioural outcomes. This means that the performance of bankers must be assessed in a balanced way using both financial and behavioural (i.e. non-financial) key performance indicators (**KPIs**).

57 For example, since NAB's 2016/2017 financial year, NAB has assessed banker performance by reference to "performance plans". Performance plans use a balanced approach by assessing individual banker performance (which determines eligibility for NAB's Group Short Term Incentive Plan) in four areas: the "conduct gate", "core expectations", "stretch expectations" and "values and behaviours".[34]

58 The "conduct gate" requires an employee to comply with all policy and compliance standards applicable to their role. An employee must pass the conduct gate to be eligible for participation in the incentive scheme. This requires a rating of either amber or green; but an amber rating results in a 25% reduction of any variable reward.[35]

59 The "core role expectations" define the main responsibilities and requirements that must be fulfilled by the banker. A core role outcome of "not achieved" means that the employee is not eligible for any variable reward, irrespective of his or her performance against stretch expectations.[36]

60 The "stretch expectations" consist of role-specific performance goals, as well as a mandatory risk and compliance performance goal. Delivery of stretch expectations qualifies an employee to participate in the incentive scheme.[37] Where the mandatory risk and compliance goal is not achieved, the overall outcome achieved by the employee cannot be higher than "partially achieved".[38]

[34] Exhibit 3.184, WIT.001.0047.0001, Statement of Howard William Silby dated 29 May 2018 with exhibits tendered as exhibit 3.184.1-3.184.36 (**Silby Statement**), [45] to [49] and Silby Statement, tab 24, NAB.005.369.0016.
[35] Silby Statement at [58(a)].
[36] Silby Statement at [47].
[37] Silby Statement at [48].
[38] Silby Statement at [64(b)].

61 The "value and behaviours" assessment measures how an employee has performed against the NAB values and behaviours relevant to the role.[39]

62 **Question 2:** *Should lenders be required to clearly draw the cross-collateral clause and its effects to the attention of borrowers? If so, how should this be done?*

63 **NAB's response:** NAB considers that the provision and availability of cross-collateral (i.e., where security pledged in respect of one facility is used as security for other facilities held by the borrower) plays an important role in providing flexibility to small business customers seeking funding.[40]

64 NAB's standard form business lending contracts do not themselves contain cross-collateral clauses - the provision of cross-collateral is effected by execution of separate security documents. However, NAB's standard form business lending contracts provide for the listing of all security pledged in support of any borrowings under the facility. This identifies for borrowers the security pledged or linked to the obligations under the loan by virtue of any guarantee, whether or not that is by way of cross-collateral.[41]

65 NAB accepts more generally that it is good practice for lenders to ensure that borrowers are informed about the existence and effect of the provision of cross-collateral. However, NAB cautions against imposing a specific obligation or requirement of that nature on lenders. It is important for borrowers to ensure that they understand the broader set of obligations and requirements that apply under the arrangements entered into (and not just those relating to cross-collateral).

66 Further, in NAB's view, and consistently with evidence given by Mr Welsh of Westpac,[42] it is not appropriate to impose prescriptive statutory requirements about the level or detail of information required to be provided by lenders as this may give rise to unnecessary and increased complexity for the customer. This is because the way in which the customer may be best informed and the level of information

[39] Silby Statement at [64(c)].
[40] This is consistent with the evidence given by Mr Welsh of Westpac: see Welsh XXN, T2464.22-23 and 44-46.
[41] See for example, Cash Statement, tab 1, NAB.005.184.1679 at .1715 under "Your assets / premises to be used as security for the Facility".
[42] Welsh XXN, T2465.31-42.

required to achieve that end depends on a range of factors, including the complexity of the clause, the nature of the facility and the sophistication of the borrower.

NAB National Music / Dillon Case Study

67 **Question 3:** *When and how much disclosure should a bank provide a director of a business in respect of a decision of the bank's workout division, in this case, the SBS division of NAB, where that decision will affect a customer's use of a personal asset which indirectly secures the obligations of their business to the bank?*

68 **NAB's response:** NAB has addressed this question as part of its submission on the National Music / Dillon Case Study dated 8 June 2018.

G. TOPIC 6 – REGULATION AND SELF-REGULATION

69 **Question 2:** *Has ASIC's approach been effective in ensuring compliance with the UCT provisions that came into effect in 28 November 2016 and the consumer protection provisions of the ASIC Act generally?*

70 **NAB's response:** NAB is not in a position to comment on the effectiveness of ASIC's approach, and does not propose to do so. However, NAB does consider that its own approach to the implementation of the unfair contract terms (**UCT**) legislation was appropriate and effective.

71 Between April and November 2016, NAB undertook a program of work, known as the "UCT Review", to update its standard form business lending contracts ahead of the extension of the UCT legislation to small business contracts in November 2016.[43] The purpose of the UCT Review was to ensure that NAB was compliant with the UCT legislation and to ensure that its contractual terms were fairer and clearer for small business customers.[44]

[43] With effect from 12 November 2016, the unfair contract terms provisions applying to consumers under the Australian Consumer Law were introduced into Part 2 Division 2 of the *ASIC Act 2001* (Cth) and extended to cover standard form small business contracts. For loan contracts, the new laws generally cover small business loans of up to $1 million.
[44] Exhibit 3.149, WIT.0001.0051.0001, Statement of Ivan "John" Mardjetko dated 16 May 2018 with exhibits tendered as exhibit 3.149.1-3.149.5 (**Mardjetko Statement**) at [9].

72 The UCT Review was undertaken with the assistance of internal and external legal counsel.[45] On 11 November 2016, a written attestation was provided to NAB's overall project sponsor confirming that the UCT Review was complete and that NAB was compliant with the UCT legislation.[46]

73 On 3 February 2017, the Australian Small Business and Family Enterprise Ombudsman (**ASBFEO**) published her report into small business loans (**Carnell Inquiry**). Around the same time, ASIC and the ASBFEO commenced a review of small business loan contracts offered by the four major banks.

74 In response to the recommendations arising from the Carnell Inquiry and its consultations with ASIC and the ASBFEO, NAB undertook a further program of work in 2017 to update its standard form business lending contacts known as the "BLO Re-Write".[47] The reference to BLO is to NAB's business letter of offer, which is NAB's main standard form contract for business lending of less than $50 million.[48] The vast majority of the lending facilities that NAB offers to its business customers are provided under the BLO.[49]

75 The BLO Re-Write was directed to a different purpose, and responsive to a wider set of considerations, than the UCT Review conducted in 2016. Unlike the UCT Review, the BLO Re-Write involved a complete review and re-write of the BLO from the "ground up".[50] Further, during the course of the BLO Re-Write, NAB worked collaboratively with ASIC and the ASBFEO in relation to particular types of clauses, including indemnification clauses, unilateral variation clauses and non-monetary event of default clauses. This resulted in changes to the BLO that went beyond the scope of the requirements of the UCT legislation.

76 **Question 3:** *Is the proposed code, whether or not it is approved by ASIC, adequate to address any residual concerns about the coverage of obligations imposed on the banks? Would the absence of ASIC approval undermine the effectiveness of the code?*

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[45] Mardjetko Statement at [11].
[46] Mardjetko Statement, tab 3, NAB.005.425.0001.
[47] Cash Statement at [15].
[48] Exhibit 3.131, WIT.0001.0034.0001, Statement of Howard Silby dated 23 May 2018 with exhibits tendered as exhibits 3.131.1-3.131.77, at [31].
[49] Cash Statement at [9].
[50] Cash Statement at [20].

77 **NAB's response:** NAB is a strong supporter of the Code. It has been a signatory since 1993 and was an active participant in the recent review of the Code. In particular, NAB considers that the Code plays, and that the Proposed Code will play, an important role in setting standards of practice and service that individual and small business customers, and their guarantors, can expect.

78 To date, the Code has been an effective form of self-regulation and, in NAB's view, the absence of ASIC's approval would not undermine that effectiveness.[51] Nevertheless, NAB looks forward to ASIC approving the Proposed Code.

12 JUNE 2018

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[51] This is consistent with the position of the ABA in its submission to the independent review of the ABA Code of Banking Practice conducted by Mr Phil Khoury: see Bligh Statement, Tab 17, ABA.001.002.0677 at .0699