

Australian Prudential Regulation Authority

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2 December 2011

Mr Thos Gieskes
 Chief Executive Officer
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Dear Mr Gieskes

**RABOBANK AUSTRALIA LIMITED
 CO-OPERATIEVE CENTRALE RAIFFEISEN-BOERENLENNBANK (AUSTRALIA BRANCH)
 TARGETED REVIEW - 2010/11
 COLLATERAL AND FORECLOSURE MANAGEMENT**

Rabobank participated in the ADI Tripartite Review for 2010/11 on Collateral and Foreclosure Management and this letter sets out the Review's major observations. The first half of this letter outlines the industry wide findings and the second half contains the issues specific to Rabobank that arose from the Ernst & Young report.

INTRODUCTION

Most Australian ADIs mitigate credit risk (on and off balance sheet) by requiring collateral as security. This collateral is often a mortgage over real estate but may also include financial assets, non-financial assets and guarantees. ADIs have collateral management systems and processes to track collateral and the exposure it secures.

Recent experiences in overseas markets, and particularly the United States, have highlighted the importance of ADIs having appropriate policies, procedures and resources in place to manage problem loans and dispose of the collateral. While the Australian market has yet to experience the level of foreclosures of the United States, recent financial reporting disclosures and APRA credit risk reviews of these processes indicate ADIs' collateral management systems as an area of weakness.

For the 2010/2011 Targeted Review, external auditors were required to assess the strengths and weaknesses of the ADI's compliance with relevant prudential standards, collateral management governance framework, collateral management systems and reporting, valuation processes, custodial arrangements and foreclosure management. Thirteen banks participated in the review.

The key prudential requirements for compliance by the ADIs in their collateral management arrangements are:

- Paragraph 6 of Attachment C of Prudential Standard APS 112 *Capital Adequacy: Standardised Approach to Credit Risk*;
- Paragraphs 6 to 14 of Attachment G of Prudential Standard APS 112 *Capital Adequacy: Standardised Approach to Credit Risk*;

- Paragraphs 13 to 30, inclusive, of Guidance Note AGN 220.2 *Impairment, Provisioning and the General Reserve for Credit Losses*.

INDUSTRY OBSERVATIONS IN RELATION TO COLLATERAL MANAGEMENT PROCESSES

Good practices observed

1. Some ADIs' have well managed valuation processes which utilise valuation management and assessment systems to improve controls, preventing potential manipulation of the valuation process.
2. A centralised repository for risks and controls, ensuring standardised risk definitions across the group which is expected to strengthen its governance framework.
3. A risk framework around lending approval decisions for commercial property sector is enhanced by the involvement of a specialist property credit risk team for assessing deals.
4. Centralised systems successfully track the annual review of collateral management policy documentation ensuring they are subject to timely review.
5. Retrieval of original security packets is restricted to staff in the custody team within one bank's Australian operations, which provides for greater control over the physical location of security documents.

The key deficiencies across the ADI industry included:

1. **Lack of completeness and accuracy of data in collateral management systems**
 - 1.1 The lack of completeness and accuracy of data in collateral management systems resulting from undue reliance on manual intervention to record collateral and asset data appears to be a common issue across the industry. APRA's expectation is that IRB status banks in particular would rely on a centralised collateral management system as part of their normal risk management practices.
 - 1.2 Instances were found where there was inadequate control over the retention and storage of key contractual loan documentation, which could hamper the enforceability of the bank's claims on collateral (non-compliance with AGN 220.2 paragraph 14).
 - 1.3 The other issues identified with collateral management systems centred on:
 - Data reconciliation issues (including instances where the most recent collateral information did not agree to that recorded in the system);
 - Manual processes increase the risk of compromising data integrity;
 - Making amendments without appropriate secondary review;
 - Reporting failing to capture all collateral data; and
 - Limitations in the collateral management systems (e.g. inability to aggregate collateral).

Weaknesses in the completeness and accuracy of data in collateral management systems not only hamper enforceability of the bank's claims on collateral, but also represent a risk for securitisation, covered bonds and other arrangements where large pools of mortgages are offered as collateral.

2. Lack of compliance with or inadequate valuation policies and processes

- 2.1. Lack of regular valuation of collateral due to inadequate collateral valuation policies or non-compliance with valuation policy (non-compliance with AGN 220.2 paragraph 23 and APS 113 Attachment B paragraph 13(c)).
- 2.2. Lending policies do not contain specific requirements (triggers) that ensure that the real estate held as security is re-valued when there is a material change in the market value of real estate within an area or region (non-compliance with APS 112 Attachment C paragraph 6). APRA's expectation is that any revaluations would be on a risk based approach and that the ADI would factor this information into provisions.
- 2.3. Inadequate documentation of rationales behind policy exception approvals. Given the lack of documentation describing the rationales for approving such exceptions, it is difficult for the bank to understand and analyse the nature of these exceptions.
- 2.4. No formalised policies and procedures in place pertaining to the use of internal valuers, in terms of criteria, process and ensuring the quality of internal valuations.

3. Lack of detailed foreclosure contingency plans that enable scale up of foreclosure operations.

Formalised foreclosure contingency plans were either insufficiently detailed or did not exist. These plans would enable scale up of foreclosure operations in the event that deteriorating economic conditions lead to a significant increase in defaults. This is an issue across all participants.

Items specific to Rabobank (Ernst & Young Report)

APRA was aware of the contents of the Ernst & Young targeted review report before our recent Prudential Consultation and so we took the opportunity to discuss many of the issues raised in the report including the status of the remedial actions.

There were however a number of open issues that had yet to be fully resolved or where additional information was required and these are highlighted below along with our request for a status update. We require a response to this request within four weeks and we intend to follow up on the more significant issues as part of a credit review that will be performed in 2012.

Finding 6 - Workflow Limitation

Ernst & Young found that if the settlements team notice an error or inconsistency in the documentation, the system allows the team member to make changes to the

file before it is processed. Hence, this capability does not reinforce adequate segregation of duties.

The Rabobank response was that this finding relates to one specific aspect of the settlement process with regard to the Drawdown Form. The ability of the settlements team to make changes to the file arises because of last minute adjustments to settlement/payout figures, however, whenever an adjustment is required the Form is reworked from Credit back to front office to make the amendments. This manual control is considered adequate by Rabobank but is being enhanced in the replacement Workflow so it is a system control, with the new system scheduled for release in Oct 2011.

APRA requests an update on enhancements made via the replacement Workflow and the subsequent new system control.

Finding 8 - Valuations performed by the originator

Ernst & Young have noted that in the majority of cases the loan originator also values the collateral, and although the loan is reviewed every 3 years, the valuation is updated by the same individual. It is perceived that in this regard, collateral management systems are not independent of the business origination function. There is a risk the collateral may be overvalued by the originator either intentionally or in error.

APRA's concerns are not with the same individual performing subsequent loan reviews, but cases where the originator of the loan is also responsible for performing the initial collateral valuation. APRA notes Rabobank's "4 eyed protocol", however, where the originator of the loan is also responsible for performing the initial collateral valuation, the independence of the process is weakened. Moreover, as stated by Ernst and Young, there is a risk that the collateral may be overvalued by the originator either intentionally or in error.

APRA requests details on the policy or procedural changes that now ensure there is sufficient independence between the collateral valuation process and the credit origination function.

Finding 9 - AMR/CR - Valuation due date maintenance

The Ernst and Young report stated that Rabobank policy indicates valuations should be obtained at least every 3 years, however, Ernst and Young's review of the process noted there were not adequate controls in place to safe guard the integrity of the renewal dates in the system.

APRA notes Rabobank has acknowledged the finding, with system controls in regard to date fields to be reviewed, and where deficiencies found, changes implemented.

APRA requests an update on the review of the relevant system controls when complete.

Finding 10 - AMR/CR - Review due date maintenance

Rabobank policy indicates that an AMR or CR should be performed at least once a year, however, Ernst and Young observed that there were not adequate controls in

place to safe guard the integrity of the renewal dates in the system. Staff members have the ability to change the renewal dates at their own discretion, with no secondary check to ensure dates are changed appropriately.

APRA notes Rabobank have stated the finding will be addressed in conjunction with Finding 9.

APRA requests an update on the review of the relevant system controls when complete.

Finding 14 - Centralised Electronic Storage of Significant Documents

The Ernst and Young report noted all deeds and other important security related documents are filed adequately and retained as required. However, in the interest of better practice, Ernst and Young has recommended Rabobank consider centrally filing important documentation electronically.

APRA notes Rabobank has stated that all important documents are retained in a secure, restricted access and fireproof strong room. However, the recommendation related to this finding is noted by Rabobank as one of best practice and will be investigated for practicality and appropriateness.

APRA requests an update regarding Rabobank's investigation into the practicality and appropriateness of the recommendation.

Should you wish to discuss or clarify any matters in this letter, please contact Phillip Clift on [REDACTED] or Lloyd Bennett on [REDACTED]

Yours sincerely

[REDACTED]

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