National Australia Bank
800 Bourke St
Docklands VIC 3008
15 May 2017

Ms Diane Brown
Division Head
Financial System Division
Department of Treasury
Via email: Diane.Brown@treasury.gov.au

Dear Ms Brown

RE: MAJOR BANK LEVY

Further to the consultation on Thursday 11 May, I write to provide feedback on the proposed *Major Bank Levy* ("levy") on behalf of National Australia Bank Limited ("NAB").

Before commenting on the mechanics of the levy, NAB would like to briefly comment directly on the policy itself. NAB believes the levy is poor policy and, accordingly, does not support it. The levy is not just on banks, it is a tax on every Australian who benefits from, and is part of, the banking industry. This includes NAB's 10 million customers, 570,000 direct NAB shareholders, those who own NAB shares through their superannuation, our 1700 suppliers and NAB's 34,000 employees. The levy cannot be absorbed; it will be borne by these people. It is not possible to increase taxes by this magnitude without it impacting people. Further, given the levy is being enacted for the purposes of budget repair, NAB looks forward to discussions with the Department of Treasury ("Treasury") on arrangements for the sun-setting of the legislation once the stated objectives have been met.

NAB appreciates the opportunity to provide this written feedback, but notes that being asked to do so in just two business days is highly unusual and reflects poorly on Australia's public policy making process. NAB has a long history of engaging with Treasury on reforms associated with the Australian economy and banking sector. While we are confident this will continue in the future, we note that the process involving this levy has been an aberration. It is in the best interests of all Australians that this matter be slowed down so unintended consequences and economic implications can be better understood.

This submission relates to the application and mechanics of the proposed levy and how it is calculated. NAB's feedback is informed by the following six objectives:

1. Seek to minimise any adverse consequences impacting market stability and liquidity;
2. Consider the impact on Australian ADI competitiveness versus global competitors;
3. Minimise double counting and asymmetry between accounting and the true economics of activities;
4. Apply the levy in a simple manner;
5. Address unwanted volatility in the levy; and
6. Consider the methodologies adopted in foreign jurisdictions for bank levies.

Based on these principles, NAB would like to highlight seven areas of concern for Treasury's consideration while drafting legislation to enact the levy. These seven areas are not an exhaustive list and do not include more obvious areas of concern, such as the calculation burden and the application of a clear disadvantage against global competitors in wholesale and institutional banking. NAB also expects that given the significance of the change and time allowed for consideration, there will be other consequences we have not currently identified.

1. Regulatory Impact Statement

NAB requests the production of a Regulatory Impact Statement (RIS) and a period of public consultation on the draft legislation.

NAB requests the production of a RIS on this change. A RIS is vitally important as it will assist in identifying unnecessary complexity. The RIS process would also help in the consideration of whether a post implementation review should be undertaken. Such a measure would assess the extent of unintended consequences and ensure that the levy was having the impact desired by policy makers.

It would be disappointing if a reform of this nature and scale was not assessed through the normal RIS process. To proceed with this reform without a RIS would also be inconsistent with the Government's ongoing approach to regulatory reform, which focuses on reducing the regulatory burden on businesses and the broader economy.

NAB would also encourage a period of public consultation on the draft legislation once it is finalised. It is inappropriate that impacted banks will have only 24 hours to comment on draft legislation (as Treasury indicated on Thursday 11 May). APRA and the RBA should also be included in this consultation.

2. Treatment of Derivatives

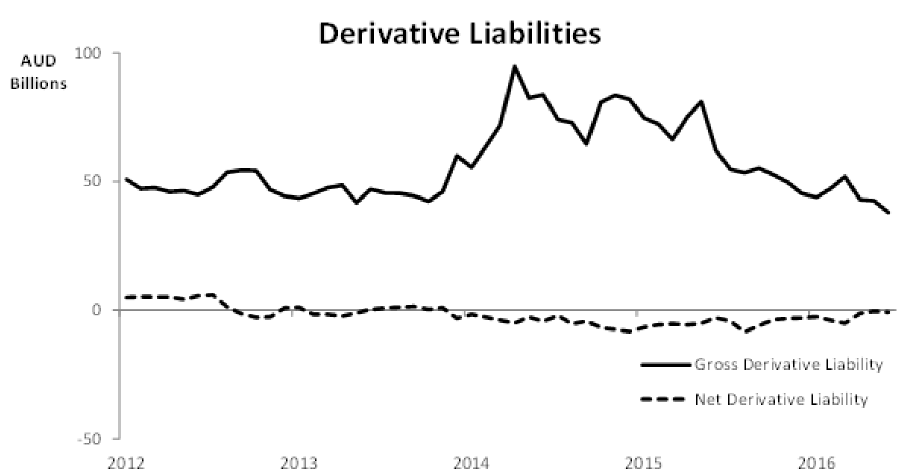
NAB recommends the levy be applied to the netted derivative balance sheet and collateral position.

Derivatives operate in a global, low margin and highly regulated environment. Given this, applying the levy on a simplistic accounting liability basis will have a material impact on Australian financial markets.

Additionally, a levy which disadvantages the Australian majors will either see activity migrate to global investment banks, who are the other major participants in the market (as opposed to smaller domestic ADIs), or result in reduced liquidity for derivatives.

There are a series of issues with a levy calculation that includes derivatives on an accounting liability basis. These include:

- The counting of the derivative liability and the funding of the collateral for that position in the levy calculation is duplicative (as is counting the collateral liability without considering the derivative asset);
- The derivative liability is typically directly related to the banks' own position (e.g. foreign currency funding) or a position with a customer (e.g. an FX swap with a corporate which is then hedged with an offsetting position into the external market). As such, only including the liability in the levy calculation does not represent the true underlying economics of the position and could cause distortion;
- The gross derivative liability position for a bank is volatile and a function of the change in market prices (given it often represents one side of an economically hedged position). Applying the levy on the gross position would produce volatile and unpredictable tax receipts and costs for the banks. See table below:



Source: NAB Internal Reporting

To address these concerns, NAB believes it is important the levy be applied to the netted derivative and collateral position. This will avoid duplication of the levy and the creation of risk in what are currently economically hedged transactions, ensuring a more stable levy base and minimising a significant

disadvantage to Australian banks competing in a global market. In support of this recommendation, NAB notes:

- International Financial Reporting Standards (IFRS) (unlike US Generally Accepted Accounting Principles) disallow the netting of derivative assets and liabilities, even when these positions are subject to master netting agreements. This treatment results in the recognition of a gross derivative liability that is not reflective of the funding requirements for derivatives activity. To address these issues and to align with Basel II principles, Australian regulators allow for some purposes to take into account situations where exposures on the asset side of the balance sheet may be reduced by legally enforceable netting arrangements with liabilities (i.e. calculation of risk weighted assets and large exposure to counterparties).
- Consistent with the above, NAB notes the UK allows for netting for items relating to derivatives and collateral.

3. Inter-company balances – including Internal Residential mortgage-backed securities (RMBS)

NAB recommends that the basis for the levy be adjusted for the impacts of the accounting gross ups which occur as a function of inter-company transactions.

Based on the information available, NAB understands the levy will apply to National Australia Bank Limited (the Company) rather than the NAB Group balance sheet. A consequence of this is that inter-company transactions with consolidated securitisation vehicles and subsidiaries will be captured as part of the calculation. These activities currently gross up the balance sheet size at the company level by over $110bn (see Appendix A – item "due to controlled entities"). There are a range of internal transactions that will be captured by the levy; however the main source is from NAB's internally generated residential mortgage backed securities (RMBS).

RMBS trusts are essential for Australian banks to comply with Basel III liquidity requirements and also ensure a more diversified funding base. As part of their structure, they effectively borrow and then lend funds back to NAB. This increases NAB's accounting liabilities; however these are directly offset by an asset on the same balance sheet.

The application of the levy on inter-company balances generates an incentive to reduce their size. With respect to internal RMBS, NAB believes that likely outcomes of this approach will be inconsistent with the policy objective of 'unquestionably strong'. Consequently, this provides a disincentive to hold buffers above regulatory minimums. Examples of this include:

- The effective double application of the levy to secured funding (e.g. covered bonds). Secured funding represents an important source of funding diversity for the Australian majors and is an especially important source of funding in periods of market stress; and
- Internal RMBS is an important source of regulatory liquidity (via the RBA's Committed Liquidity Facility) as well as additional contingent liquidity for the banks. A reduction in internal RMBS balances by the system represents a reduction in the level of protection held for liquidity stress events.

Given inter-company balances do not represent a true underlying liability; NAB believes it is essential that they are excluded from the calculation of the levy. In support of this NAB notes that:

- APRA recognises that the assets and liabilities associated with internal RMBS are not true underlying positions by excluding them from regulatory capital and exposure requirements; and
- NAB understanding of the calculation approach and accounting practice in the UK, results in this not presenting a significant issue for the levy in the UK.

4. High Quality Liquid Assets/Regulatory Liquid Assets

NAB recommends that the funding of high quality liquid assets be excluded from the levy calculation.

The level of liquid assets banks hold for regulatory liquidity purposes has significantly increased in recent years, aligning to the implementation of APRA's Liquidity Coverage Ratio (LCR). High Quality Liquid Assets (HQLAs) represent the most liquid securities in wholesale credit markets.

Given HQLAs are the primary mitigant against liquidity risk and contribute to the policy objective of "unquestionably strong", NAB believes that HQLAs should be excluded from the levy calculation. This

would align with the current proposal to exclude Tier 1 capital and ensure the levy does not produce any incentives in the system to reduce liquidity buffers.

NAB proposes HQLA be defined as total regulatory liquidity, as reflected in the numerator of the Level 1 LCR, with data sourced from cell BSA042320 ARF210.1A All Currency Level 1 return.

NAB also notes that this proposal closely aligns to the UK approach.

5. Repurchase Agreements

NAB recommends that repurchase agreements be excluded from the calculation of the levy.

Repurchase agreements provide an important source of liquidity for debt capital markets. At in excess of $200bn in size,[1] repurchase agreements play a critical role in enabling the efficient movement of cash in financial markets. Australian major banks, via repurchase agreements, play an important role in the intermediation of primary issuance, the provision of liquidity in the secondary market for bonds and also cover the RBA's open market operations (which in turn support RBA cash rate management).

The application of the major bank levy may materially impact these systemically important activities by dis-incentivising banks to:

- Provide support for primary issuance (e.g. from the Australian Office of Financial Management);
- Provide liquidity in secondary markets; and
- Transact in the interbank market.

The implications of the reduction in these activities could be significant and may include a reduction in market liquidity, higher primary issuance costs and reduced incentive for banks to transact at the RBA target cash rate.

In aggregate, repurchase agreements are almost entirely backed by HQLA (e.g. Commonwealth and State Government Bonds). As such, NAB suggests that excluding repurchase agreements from the levy calculation would be appropriate, ensuring continued promotion of liquidity in these markets.

The Australian banks' reporting of their balance sheet itemises repurchase agreements, which would readily support the adjustment of the levy calculation.

6. Non-Funding Liabilities

NAB recommends the exclusion of non-funding liabilities, in particular, liabilities and provision for taxes and the levy.

Bank liabilities include a number of items that do not require funding:

- Current tax liabilities;
- Deferred tax liabilities;
- Provision for payments of other taxes (including the levy when enacted);
- Provision for employee entitlements; and
- Provision for expenses, including trade payables to suppliers.

These liabilities represent accrued expenses of a bank that are accounted for in its profits and reflected in the retained earnings of a bank.

NAB notes that the design of the levy is to impose a charge on the funding liabilities of a bank. Therefore, it is desirable to ensure that the tax base of the levy excludes items of non-funding liabilities.

In particular, imposition of the levy on current tax liabilities, deferred tax liabilities and provisions for GST and other taxes represents a tax on tax. This view is supported by the International Monetary Fund, which stated that in designing the tax base of a levy it is desirable to ensure there is no double taxation.[2] NAB notes that the UK banking levy excludes certain liabilities, including current tax liability, deferred tax liability, retirement benefit liabilities and client money, where the bank acts as collecting agent.

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[1] RBA Quarterly Bulletin, September 2016, Table 1, p42.

[2] International Monetary Fund, 'A Fair and Substantial Contribution by the Financial Sector', Final Report for the G20, June 2010, p17.

It is therefore sensible and desirable to exclude all non-funding liabilities from the relevant tax base for the levy.

7. Anti-avoidance measures and underpayment penalties

NAB recommends that, if included, only targeted anti-avoidance measures are contained in the legislation. NAB also recommends that discretion be applied on any penalties for under payment.

Banking liabilities are subject to ongoing fluctuations due to a range of factors (including external market conditions and risk appetite settings), such as:

- The growth and reduction of assets, including lending assets;
- Changes in liquidity to meet relevant prudential requirements;
- Fluctuation in value of derivatives and other securities that are subject to fair value treatment;
- Collateral positions with counterparties; and
- Other fluctuation in unhedged positions.

It should be recognised that such movements in liabilities, which can be significant in size, are a natural and inherent feature of prudent balance sheet and liquidity management of a bank.

NAB acknowledges that ensuring the integrity of the levy is important. NAB notes that the UK banking levy has included specific anti-avoidance measures targeted at certain arrangements that are entered into with the main purpose of intending to avoid or reduce the levy. If such arrangements are entered into, the levy is calculated as if such arrangements did not exist (see UK *Finance Act 2011* (UK), schedule 19, paragraph 47). NAB also notes that the UK rules specifically exclude from their anti-avoidance measures genuine commercial arrangements that would:

- Increase the equity of the group or changes to the equity and liabilities of the group, on an ongoing basis;
- Increase the amount of high quality liquid assets of the group; or
- Would otherwise impact the normal business operations of the group.

In introducing any anti-avoidance measures in the legislation, NAB encourages Treasury to ensure these measures are targeted. This will ensure the measures do not affect genuine balance sheet, capital and liquidity management practices in the market.

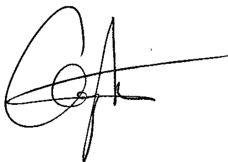
If the levy begins on 1 July 2017, NAB recommends some discretion be applied to penalties for underpayment of the levy in the first 12 months of the levy's operation given the truncated timeframe of consultation before the levy's implementation.

Conclusion

If you have any further questions about this submission please contact Dallas McInerney, General Manager Government Affairs & Public Policy on [redacted] or [redacted]

We look forward to receiving the draft legislation to provide further feedback.

Yours sincerely,



Gary Lennon

Group Chief Financial Officer

National Australia Bank

Appendix A

Balance sheets

As at 30 September	Note	Group 2016 $m	Group 2015 $m	Company 2016 $m	Company 2015 $m
Assets					
Cash and liquid assets	9	**30,630**	30,934	**28,717**	24,308
Due from other banks	9	**45,236**	50,595	**43,359**	37,698
Trading derivatives	10	**43,131**	78,384	**42,440**	79,149
Trading securities	11	**45,971**	42,937	**41,513**	38,512
Debt instruments at fair value through other comprehensive income	12	**40,689**	45,189	**40,580**	41,944
Investments relating to life insurance business [1]		**86**	89,350	**-**	-
Other financial assets at fair value	13	**21,496**	29,696	**14,831**	19,304
Hedging derivatives	10	**6,407**	11,599	**5,996**	11,219
Loans and advances	14	**510,045**	532,784	**441,321**	413,989
Due from customers on acceptances		**12,205**	19,437	**12,205**	19,428
Property, plant and equipment	20	**1,423**	1,741	**520**	533
Due from controlled entities		**-**	-	**119,414**	110,241
Investments in controlled entities	30	**-**	-	**9,493**	20,434
Goodwill and other intangible assets	21	**5,302**	7,347	**2,093**	1,855
Deferred tax assets	8	**1,925**	2,141	**1,172**	1,257
Other assets	22	**13,076**	12,918	**10,681**	9,832
Total assets		**777,622**	955,052	**814,335**	829,703
Liabilities					
Due to other banks	9	**43,903**	54,405	**42,649**	51,938
Trading derivatives	10	**41,654**	74,442	**38,949**	73,459
Other financial liabilities at fair value	16	**33,224**	30,046	**5,408**	6,958
Hedging derivatives	10	**3,245**	4,539	**6,458**	8,564
Deposits and other borrowings	17	**459,714**	489,010	**416,241**	391,785
Life policy liabilities [1]		**-**	76,311	**-**	-
Current tax liabilities	7	**297**	1,114	**248**	996
Provisions	23	**1,432**	3,575	**1,157**	917
Due to controlled entities		**-**	-	**117,399**	106,703
Bonds, notes and subordinated debt	18	**127,942**	130,518	**123,226**	119,136
Other debt issues	19	**6,248**	6,292	**6,248**	5,652
External unitholders' liability [1]		**-**	14,520	**-**	-
Other liabilities	24	**8,648**	14,767	**7,800**	8,378
Total liabilities		**726,307**	899,539	**765,783**	774,486
Net assets		**51,315**	55,513	**48,552**	55,217
Equity					
Contributed equity	25	**34,285**	34,651	**32,524**	34,407
Reserves	26	**629**	(362)	**309**	340
Retained profits	27	**16,378**	21,205	**15,719**	20,470
Total equity (parent entity interest)		**51,292**	55,494	**48,552**	55,217
Non-controlling interest in controlled entities		**23**	19	**-**	-
Total equity		**51,315**	55,513	**48,552**	55,217

[1] Balances were impacted by the SuccessorFund Merger on 1 July 2016 and the sale of 80% of NAB Wealth's life insurance business. Refer to Note 41 - Discontinued operations for details.

Source: NAB Full Year 2016, Annual Financial Reporting, p64