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National Australia Bank

8 June 2022

Sector: Financials
Sub-sector: Banks
Country: Australia
Ownership: Public

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Issuer Outline

National Australia Bank (NAB) is one of the four major banks in Australia and New Zealand, accounting for around a quarter of business and private banking in Australia (slightly less in New Zealand) and around a sixth of personal banking in both Australia and New Zealand. NAB has a market capitalisation of ~AUD97bn as at June 2022.

The bank provides personal banking and business/corporate banking services across four main operating divisions: Business and private banking (AUD2,480m FY21 cash earnings), Personal banking (AUD1,650m), Corporate and institutional banking (AUD1,207m), and New Zealand banking (AUD1,154m).

Key Financials (AUDm)

LTM (31 March)	2022
Net interest income	14,029
Non-interest income	3,516
NPAT	6,708
Gross loans	659,681
Customer deposits	654,780
Net interest margin (%)	1.63
Non-performing loans (%)*	0.75
Credit (losses) / benefit (%)	0.09
CET 1 ratio (%)	12.5

*Source: Company, FIIG Securities. *As measured by stage 3 loans (impaired and 90-days past due)*

Summary Bond Details

ISIN	Issue Amount	Ranking	Coupon	Coupon Frequency	First Call[1]	Maturity Date
AU3FN0048195	AUD1,000m	Unsec. Sub. T2	3mBBSW + 2.15%	Quarterly	17 May 2024	17 May 2029
AU3FN0051587	AUD1,175m	Unsec. Sub. T2	3mBBSW + 2.02%	Quarterly	18 Nov 2026	18 Nov 2031
AU3CB0268423	AUD225m	Unsec. Sub. T2	3.225%	Semi-Annual	18 Nov 2026	18 Nov 2031
AU3FN0055224	AUD600m	Unsec. Perpetual T1	3mBBSW + 4.00%	Quarterly	17 Jul 2025	Perpetual
AU3CB0269215	AUD500m	Unsec. Perpetual T1	4.95%[2]	Semi-Annual[2]	12 Dec 2029	Perpetual
AU3CB0289817	AUD1,100m	Senior Unsecured	3.90%	Semi-Annual	N/A	30 May 2025
XS1550984816	AUD275m	Sub. T2 Debt	5.00%	Annual	19 Jan 2027	19 Jan 2032

[1]Excludes potential terms that would allow the issuer to redeem prior to the maturity date through a make-whole call.
[2]Resets on 12 December 2029 to BBSW+3.75%, with payment frequency changing to quarterly.

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Perpetual Tier 1 (AT1) / Tier 2 Structure	
Interest Deferral/Cancellation	Interest is deferrable for both Tier 1 and Tier 2 notes and is also non-cumulative for Tier 1 notes. In the case of Tier 2 notes, interest is only typically deferred in the highly unlikely circumstances that the payment would result in the bank becoming insolvent. Interest payment for Tier 1 notes is optional and, if unpaid, the issuer has no obligation to pay any deferred amounts later. A cancellation of interest does not constitute a default under the terms of a Tier 1 note for any purpose.
Common Equity Tier 1 Trigger	If the issuer or prudential regulator determines that the then applicable Common Equity Tier 1 capital ratio falls below 5.125% on a consolidated basis, they may be required to convert into equity or write-off some or all the face value of its Tier 1 hybrids.
Non-Viability Trigger	If the prudential regulator determines that the issuer is at the point of non-viability (loosely defined as the point in which the issuer is failing or likely to fail), the issuer may be required to convert into equity or write-off some or all the face value of both its Tier 1 and Tier 2 notes. Write-off or conversion takes place in order of ranking, with losses applied to Tier 1 notes before Tier 2 (if required).
Maturity	Tier 1 notes do not have a maturity date. This means that the issuer does not have an obligation to repay the principal.

Strengths

- Dominant market position: NAB is one of the four major banks that dominate banking in Australia, accounting for around a quarter of business and private banking in Australia (slightly less in New Zealand) and around a sixth of personal banking in both Australia and New Zealand. Although major bank profitability metrics have migrated toward the middle of global peers as yields have fallen and capital requirements have increased, they are nevertheless highly profitable. Credit metrics are typically toward the stronger-end of global comparisons.
- Strong capitalisation, underpinned by high quality earnings profile: NAB exhibits a strong regulatory capital ratio, recently reporting a Common Equity Tier 1 capital ratio of 13.00% at September 30, 2021, comfortably above minimum requirements and ~AUD10.5bn above APRA's "unquestionably strong" target of 10.5% (equivalent to 1.5x – 2.0x normalised earnings).

  Composition of regulatory capital is comparable with peers for NAB, with common equity accounting for ~89% of Tier 1 capital. Quality of earnings is strong and again comparable with averages across Australia given the bank's predominant exposure to residential mortgage lending, with net interest income accounting for ~ 82% of operating revenues. Net interest income is typically viewed favourably in terms of earnings quality, as it has many recurring characteristics that are largely dependent of the ability of households and business to repay their loans.
- Relatively low-risk lending book: NAB's asset quality benefits from a focus on relatively lower risk residential mortgage lending, with the bank reporting non-performing loans (as measured by Stage 3 [impaired and past due]) of 1.20% (toward the lower end of global peers), most of which relates to housing (and as such, is well-secured). Single-name concentrations within NAB's corporate and institutional book are relatively modest by global standards.
- Sound macro environment: Australian financials, including NAB, benefit from operating in an economy characterised as having a very high degree of economic resilience with low susceptibility to event risk. Institutional and governance frameworks compare well with overseas jurisdictions. Australian banks are overseen by a highly regarded prudential regulator, APRA.
- Strong investment-grade credit ratings down the capital structure: NAB, along with its peers, remains one of the highest rated financial institutions across the globe, which extends down the capital structure (including the most junior-ranked securities (Tier 1 perpetual hybrids), which are rated investment grade).

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Risks

- Relatively high reliance on wholesale funding: Although the major banks, including Westpac, benefit from a strong funding franchise, both domestically and offshore, and across various currencies and instruments, they remain highly reliant on wholesale funding compared with global peers.

  The major banks in recent years have greatly extended the maturity of their wholesale term debt, reducing the exposure to a short-term dislocation in wholesale funding markets.

- Modest diversity by global peer standards: Like its peers, NAB exhibits a modest level of diversity by both product and geography, with its lending base heavily weighted toward residential mortgages in Australia and New Zealand. This leaves the bank primarily exposed to the performance of the Australian and New Zealand mortgage markets (and as such, the high levels of household debt in both countries).

  The exposure to residential mortgages is somewhat mitigated by mortgage loans that are full recourse and are fundamentally written with the intention to remain on the balance sheet of the bank.

Risks relevant to Subordinated Unsecured Tier 2 instruments

- Subordinated ranking: Tier 2 instruments are unsecured and subordinated instruments, ranking ahead only of ordinary shares and additional Tier 1 hybrids. Tier 2 instruments rank behind senior creditors, which includes depositors and senior unsecured creditors.

- Interest is deferrable (but cumulative): Interest is deferrable for Tier 2 capital instruments, but typically only in the highly unlikely circumstance that the payment would result in the bank becoming insolvent.

  Deferred interest does however accumulate.

- Basel III compliant structural features: Tier 2 subordinated instruments are classified as Basel III compliant Tier 2 capital instruments. As such, they contain the following features:

  - Conversion or write-down following a Non-Viability Trigger Event: If the prudential regulator determines that the issuer is at the point of non-viability (loosely defined as the point in which the issuer is failing or likely to fail), the issuer may be required to convert some or all of its Tier 2 hybrids into ordinary shares. Generally speaking, it is expected that any Tier 1 hybrids outstanding will be converted into equity before Tier 2 hybrids. Depending on the price of the ordinary shares at the relevant time, investors may suffer loss as the value of ordinary shares received by an investor may be less than the face value of the relevant hybrid.

    If, for any reason, the conversion does not take place, the face value of Tier 2 hybrids set aside for conversion will be written off and noteholders will not be compensated (including for any unpaid distributions or interest).

  - Optional call dependent on regulatory approval: Tier 2 hybrids include an early call feature where the face value of the instrument may be repaid early in cash. The optional redemption requires regulatory approval, which may not be provided.

    In general, regulators are unlikely to provide approval for a Tier 2 hybrid to be called if it results in a reduction in the issuer's capitalisation; regulators are unlikely to provide approval for a redemption or resale unless the issuer has, or is expected to, issue an instrument of similar size to replace the instrument subject to that call. To the extent the optional call was expected not to be exercised, it is likely that the price of the notes will be negatively affected.

Risks relevant to Subordinated Unsecured Tier 1 (AT1) instruments

- Deeply subordinated ranking: Tier 1 hybrids are unsecured and deeply subordinated, ranking ahead only of ordinary shares. Tier 1 hybrids rank behind senior creditors, which includes depositors, senior unsecured creditors, and non-deferrable subordinated debt (Tier 2) instruments.

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- **Basel III compliant structural features:** Tier 1 hybrids are classified as Basel III compliant Additional Tier 1 (AT1) capital instruments. As such, they contain the following features:
  - **Optional, non-cumulative interest payment:** Payment of interest is optional whereby the issuer may elect not to pay interest and this will not constitute an event of default. In some circumstances, the issuer may be prevented from paying interest on its Tier 1 hybrids. If interest is not paid, it is non-cumulative and the issuer is under no obligation to make up the payment at a later date.
  - **Conversion or write-down some or all of the face value of the notes:** If the issuer's regulatory capital levels fall below a certain level, it may be required to convert some or all of the face value of its Tier 1 hybrids into equity (as outlined below). At the same time, any indication that the issuer's capitalisation is trending toward the 5.125% threshold for a Common Equity Trigger Event Tier 1 is likely to have a materially adverse effect on the capital price of the Tier 1 instruments. Depending on the price of the ordinary shares at the relevant time, investors may suffer loss as the value of ordinary shares received by an investor may be less than the face value of the relevant hybrid.

    If, for any reason, the conversion does not take place, the face value of Tier 1 hybrids set aside for conversion will be written off and noteholders will not be compensated (including for any unpaid distributions or interest).
    - **Common Equity Trigger Event:** If the issuer or prudential regulator determines that the then applicable Common Equity Tier 1 capital ratio falls below 5.125% on a consolidated basis, the issuer may be required to convert some or all of its Tier 1 hybrids into ordinary shares.
    - **Non-Viability Trigger Event:** If the prudential regulator determines that the issuer is at the point of non-viability, the issuer may be required to convert some or all of its Tier 1 hybrids into ordinary shares.
  - **No fixed maturity:** Tier 1 hybrids do not have a fixed maturity date and are perpetual. This means that the issuer does not have an obligation to repay the notes on the relevant call date(s) and will only do so if it elects to provide a notice of redemption and obtains the relevant regulatory approval beforehand.
  - **Optional call dependent on regulatory approval:** Tier 1 hybrids include an early call feature where the face value of the instrument may be repaid early in cash. The optional redemption requires regulatory approval, which may not be provided.

    In general, regulators are unlikely to provide approval for a Tier 1 hybrid to be called if it results in a reduction in the issuer's capitalisation; regulators are unlikely to provide approval for a redemption or resale unless the issuer has, or is expected to, issue an instrument of similar size to replace the instrument subject to that call. To the extent the optional call was expected not to be exercised, it is likely that the price of the notes will be negatively affected, with this negative price movement being potentially material.
- **A portion of the notes' return will be in the form of franking credits:** Income distributed to holders of the AT1 notes on each periodic payment date will comprise a cash component and franking credits. As such, the return for an individual holder will be influenced by the value such holder can ascribe to these franking credits which will vary depending on each holder's circumstances.

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