

### Research Update:

# National Australia Bank Ltd. & Subsidiaries' Ratings Lowered On Criteria Change

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## Research Update:

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## Overview

- Following a review under Standard & Poor's revised bank criteria (published on Nov. 9, 2011), we have lowered our long-term issuer credit rating on National Australia Bank Ltd (NAB) to 'AA-' from 'AA'. Our 'A-1+' short-term rating on NAB is affirmed. The outlook is stable.
- Our ratings on subsidiaries of NAB have also been lowered following our review (see Ratings List).
- Our ratings on NAB reflect the anchor SACP for a bank operating mainly in Australia; plus the bank's strong business position, and its adequate capital and earnings, risk position, and liquidity; average funding; and potential government support.
- The stable outlook reflects our expectation that capital will continue to improve over the next 12-18 months, asset quality will not deteriorate materially, and funding risks will be satisfactorily managed.

## Rating Action

As we previously announced on Dec. 1, 2011, Standard & Poor's Ratings Services has lowered its long-term issuer credit rating on National Australia Bank (NAB) to 'AA-'. The 'A-1+' short-term rating is affirmed. Our long-term issuer credit rating on Bank of New Zealand Ltd., NAB's core New Zealand banking subsidiary, has also been lowered to 'AA-'. Our long-term issuer credit rating on Clydesdale Bank PLC, NAB's moderately-strategic U.K. banking subsidiary, has been lowered to 'BBB+'. The ratings on NAB's insurance and wealth-management subsidiaries have also been lowered (see Ratings List). All the outlooks are stable.

Further, we have withdrawn our bank fundamental strength rating on NAB.

## Rationale

Our ratings on NAB reflect the anchor stand-alone credit profile (SACP) for a bank operating mainly in Australia; plus the bank's "strong" business position, and its "adequate" capital and earnings, risk position, and liquidity; "average" funding; and potential government support.

Our bank criteria use the BICRA economic risk and industry risk scores to determine a bank's anchor stand-alone credit profile SACP, the starting point in assigning an ICR. The anchor SACP for a bank operating only in Australia is 'a-'. NAB conducts about 80% of its lending in its Australian home market. The BICRA score is informed by our evaluation of economic risk, where we view Australia as a wealthy, open, and resilient economy. We consider that build-up

of private sector credit and asset prices has eased in the recent years, and that moderate private sector debt is offset by conservative lending practices and a creditor-supportive legal framework. With regard to industry risk, our assessment of the Australian banking industry is underpinned by the country's conservative and comprehensive regulation, and the banking sector's very low risk appetite, partly offset by limited funding support from customer deposits and a material dependence on net external borrowings. Outside Australia, NAB conducts about 10% of its lending in the U.K. (which has an economic risk score of '4'), and about 10% in New Zealand (economic risk score of '3'). These countries' weaker economic risk scores compared with Australia result in a weaker weighted average economic risk score for NAB, but not to an extent that affects our anchor SACP on NAB.

The SACP for NAB is 'a'.

We assess NAB's business position as "strong", and likely to be an enduring positive feature of the bank's credit standing. NAB is one of four major banking groups dominating the Australian and New Zealand retail and commercial banking sectors. Positive business diversity is also afforded by the bank's good asset management and insurance businesses. We expect that a combination of these factors will provide a platform for long-standing business stability. NAB's U.K. banking subsidiary, however, is underperforming relative to NAB's other major businesses, and is a negative counterpoint of NAB's business position compared with the business positions of its three major Australian-based competitors. That said, this currently does not change our view that NAB's overall business position remains "strong". NAB's strategy and forward prospects are generally viewed by us as sound.

While in our view NAB's capitalization is "adequate", we note that it compares least favorably with its three major domestic competitors. Our view takes into account our expectation that NAB's capitalization under our criteria will steadily improve over the next 12-18 months to about 8% on a Standard & Poor's risk-adjusted capital basis. NAB's forward-earnings prospects remain sound and consistent with the current rating.

We assess NAB's risk position as "adequate". This is primarily because risks are well diversified across the bank's retail, commercial, and corporate banking activities, and because these sectors remain in relatively good health. Exposures to higher-risk banking activities are considered manageable at the current rating level. Although the bank's loss experience over the past 10 years compares less favorably with major domestic competitors, and included some major risk-management losses, we believe that forward prospects are more likely to remain broadly comparable with domestic peers'.

In the context that system-wide funding is considered by us to be an "intermediate" risk that negatively impacts our view of the Australian banking sector, we nonetheless consider NAB's funding to be "average" and its liquidity "adequate". Similar to other Australian major banks, NAB is considered by us to be materially reliant on wholesale funding, which we view as a negative rating factor. We note, however, that system-wide funding risks

are to a large extent taken into account by us in our downward revision of Australia's BICRA assessment, to '2' from '1'.

Our counterparty credit rating on NAB is two notches higher than the SACP, reflecting our view of a high likelihood of extraordinary government support in a crisis. We believe this is due to NAB's high systemic importance in Australia, and our assessment of the Australian government as highly supportive of institutions that are core to the national economy.

We have lowered the issue ratings on NAB's non-deferrable senior subordinated debt to 'A-' from 'AA-', which is one notch below NAB's SACP, because we believe that Australia's legal and regulatory framework could allow authorities to instigate restructuring of a failing bank to the detriment of non-deferrable subordinated debt. We note that the short-to-medium term prospects for NAB experiencing financial distress of this magnitude are low. We have likewise lowered the issue ratings on NAB's hybrid capital instruments to 'BBB', three notches below the bank's SACP. Under our criteria, the three-notch differential reflects the narrow-distributable-profits test that is applicable to hybrid-capital instruments issued by Australian banks.

## Outlook

The stable outlook reflects our expectation that NAB's capital will improve over the short-to-medium term, and that the bank's risk position will not deteriorate materially, noting that asset quality is recovering from the recent Australian economic downturn and NAB's U.K. loan write-offs. We also expect that the steady transition to improved deposit levels and longer-tenor wholesale funding can continue.

The most likely factor that we believe could contribute to a lowering of the ratings is if NAB is unsuccessful in increasing capital in accordance with our expectations. In order for us to gain enduring comfort at the current rating level, we expect that NAB will achieve a risk-adjusted capital ratio of about 8% by March 31, 2013, and that it can be maintained on an ongoing basis. We expect the same capital ratio to be achievable by BNZ. The rating could also be lowered if our view of funding weakens compared to domestic peers, or potentially if the peer group as a whole deteriorates. At the current rating level we expect that the knock-on effects of volatile global debt markets because of euro-zone stresses, or other factors, will be adequately managed; if not, it could result in negative ratings momentum. Finally, we have minimal appetite at the current rating level for NAB experiencing material losses, as we would deem it as indicating weaknesses in the bank's risk-management capabilities--should any emerge, negative ratings momentum could occur.

The ratings would also come under pressure should the sovereign rating on Australia be lowered, which would likely impact the level of government support factored into the counterparty credit rating. In our view, this is an unlikely scenario in the short-to-medium term.

We currently believe there are low prospects of positive ratings momentum in

the short-to medium term. Rather, we see NAB's challenge being to consolidate its credit-standing at the current ratings level.

We are continuing to closely monitor NAB's U.K. strategy, including the potential for positive or negative ratings developments. This is most likely to occur should NAB eventually sell Clydesdale, which we independently believe is a possibility; or alternately that NAB will retain Clydesdale and potentially build upon its U.K. beach head. In the interim, we will continue to monitor Clydesdale's SACP, which has been negatively affected by the recently difficult U.K. economic environment.

## Ratings Snapshot

Issuer credit rating	AA-/Stable/A-1+
SACP	a
Anchor	a-
Business position	Strong (1)
Capital and earnings	Adequate (0)
Risk position	Adequate (0)
Funding and liquidity	Average and adequate (0)
Support	+2
GRE support	0
Group support	0
Sovereign support	+2
Additional factors	0

## Related Criteria And Research

- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Group Rating Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010

## Ratings List

Downgraded	To	From
National Australia Bank Ltd. Certificate of deposit	AA-	AA
MLC Ltd.		
Issuer credit rating		
Local currency	AA-/Stable/--	AA/Stable/--
Financial strength rating		
Local currency	AA-/Stable/--	AA/Stable/--

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National Wealth Management Holdings Ltd.		
Issuer credit rating	A+/Stable/A-1	AA-/Stable/A-1+
National Australia Bank Ltd.		
Senior unsecured (198 issues)	AA-	AA
Subordinated (19 issues)	A-	AA-
Junior subordinated (3 issues)	BBB	A+
Preferred stock (2 issues)	BBB	A+
Certificate of deposit (1 issue)	AA-	AA
BNZ Income Securities 2 Ltd.		
Preference stock (1 issue)	BBB	A+
BNZ Income Securities Ltd.		
Preferred stock (1 issue)	BBB	A+
BNZ International Funding Ltd.		
Senior unsecured (16 issues)	AA-	AA
Bank of New Zealand		
Senior unsecured (12 issues)	AA-	AA
Subordinated (1 issue)	A-	AA-
National Capital Instruments [Euro] LLC 2		
Subordinated (1 issue)	BBB	A+
National Capital Trust III		
Subordinated (1 issue)	BBB	A+
National Wealth Management Holdings Ltd.		
Senior unsecured (5 issues)	A+	AA-
Subordinated (1 issue)	A-	A
Clydesdale Bank PLC		
Senior unsecured	BBB+	A+
Subordinated	BBB-	A-
Commercial Paper	A-2	A-1
National Australia Bank Ltd.		
Bank of New Zealand		
Counterparty credit rating	AA-/Stable/A-1+	AA/Stable/A-1+
Clydesdale Bank PLC		
Counterparty credit rating	BBB+/Stable/A-2	A+/Negative/A-1
Bank of New Zealand		
Certificate of deposit		

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Local currency	AA-	AA
Not-Rated Action		
	To	From
National Australia Bank Ltd.		
Bank fundamental strength rating		
Local currency	NR	A
Bank of New Zealand		
Bank fundamental strength rating		
Local currency	NR	B+
Ratings Affirmed		
National Australia Bank Ltd.		
Senior unsecured (39 issues)	cnAAA	
Commercial paper (1 issue)	A-1+	
BNZ International Funding Ltd.		
Senior unsecured (3 issues)	cnAAA	
Commercial paper (2 issues)	A-1+	
Bank of New Zealand		
Certificate of deposit (1 issue)	A-1+	
National Australia Funding (DE) Inc.		
Commercial paper (1 issue)	A-1+	

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