NATIONAL AUSTRALIA BANK LTD
Form 6-K
December 06, 2006

**FILE NO 1-9945**

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON DC 20549**

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# FORM 6-K

**REPORT OF FOREIGN ISSUER**

**Pursuant to Rule 13a-16 or 15d-16 of**

**the Securities Exchange Act of 1934**

**For the month of December 2006**

# National Australia Bank Limited

**ACN 004 044 937**

(Registrant s Name)

**Level 24**

**500 Bourke Street**

**MELBOURNE VICTORIA 3000**

**AUSTRALIA**

Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F.

Form 20-F x Form 40-F o

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes o No x

If Yes is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82

**National Australia Bank Limited**

ABN 12 004 044 937

This annual financial report 2006 is lodged with the Australian Securities and Investments Commission and Australian Stock Exchange Limited.

National Australia Bank Limited is publicly listed in Australia and overseas and, as such, must meet regulatory requirements of all jurisdictions it operates in internationally. This report contains information prepared on the basis of the *Banking Act 1959 (Cth)*, *Corporations Act 2001 (Cth)*, Australian equivalents to International Financial Reporting Standards, United States generally accepted accounting principles and various disclosures rules of the Securities Exchange Commission.

To view a concise version of this report, visit www.nabgroup.com. Alternatively, to arrange for a copy to be sent to you free of charge, call Shareholder Services on 1300 367 647 from within Australia, or +61 3 9415 4299.

Nothing in this report is, or should be taken as, an offer of securities in National Australia Bank Limited for issue or sale, or an invitation to apply for the purchase of such securities. All figures in this document are in Australian dollars unless otherwise stated.

**Cover: Commonwealth discus champion Scott Martin has serious talent. His determination to prove himself to push himself, to be the best that he could be in achieving gold in the Melbourne 2006 Commonwealth Games drew us to supporting him.**

**At NAB, we re inspired by people s potential to do amazing things. It s why we look to get behind people in all fields of endeavour on the sports ground, in business, and throughout their lives.**

**Your success, translates to our success and then to shareholder returns. Our involvement in the Melbourne 2006 Commonwealth Games, gave us the chance to unite key customers and stakeholders across all our businesses internationally whilst celebrating the spirit of achievement.**

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**Chairman s message**

I am pleased to report that your Company achieved good growth in profitability and steady progress in its business improvement program in the 2006 year.

Net profit attributable to members of the Company increased 10.0% to $4,392 million and cash earnings before significant items rose 21.9% to $3,967 million.

These results were achieved despite an increasingly competitive lending environment and a substantial amount of management time being devoted to improving the Bank s internal systems and complying with the requirements of new international regulatory frameworks and standards.

The Company s culture change program, initiated in 2005, is achieving early success, especially at senior levels. The program seeks to clarify individual accountability and empower employees at every level to take initiative in their day-to-day decisions and interactions.

The success of these efforts is evidenced by numerous positive developments across the Group from a recovery in the Australian bank s market share in business lending, to the growth of the Integrated Financial Solutions Centre (FSC) business in the UK, the rebuilding of nabCapital and the success of the Unbeatable home loan campaign in New Zealand.

In Australia, our efforts were recognised via Money Magazine s Bank of the Year Award, CFO Magazine s Business Bank of the Year Award and Australian Banking and Finance Magazine s Life Insurance Company of the Year Award for MLC.

Much, however, remains to be done. The principal message being conveyed by the Board to senior management, and through them to employees, is that the Company s goal of providing sustainable satisfactory shareholder returns will only be achieved through an unwavering focus on our customers needs, ethical behaviour at all levels and recognition in the community of our operating companies as good corporate citizens.

The investment of time and money by the Company in developing its systems to meet regulatory requirements is substantial. These investments will ultimately result in an even sharper appreciation of risk across the business.

In the meantime, such demands do result in a lesser focus on market-oriented initiatives than would otherwise be the case.

Increasingly in the markets in which we operate there is strong competition from non-traditional sources, which are not required to meet the same regulatory standards.

The tilting of the playing field in this way works to the detriment of banks, a development that is not in the interest of either our shareholders or our economy. At a time when governments are beginning to recognise the costly burden being placed on companies by regulation generally, this is a trend that needs to be monitored closely.

During the year, the directors declared dividends totalling 167 cents per share, a small increase on that paid in 2005. As a result of the increase in net profit attributable to members of the Company, the Company s dividend payout ratio fell from 79.6% to 67.4% which is closer to the board s target range of 60% to 65%.

In July 2006, Mr Robert Elstone resigned from the Board as a result of his appointment as Chief Executive of the Australian Stock Exchange. Rob s departure is a real loss to the Company, in particular given his keen appreciation of risk across all parts of the finance sector. Rob made a significant contribution during his two years on the Board and we are indebted to him for that.

Fortunately the Board is well placed in respect of finance industry expertise and Mr Paul Rizzo was able to assume the role of Chair of the Risk Committee seamlessly upon Rob s departure.

In closing, I would like to thank my fellow directors and the Company s employees for their dedication and effort over the past year.

/s/ Michael A Chaney AO
Michael A Chaney AO
Chairman

**Group Chief Executive Officer s message**

**2006 at a glance**

- Net profit attributable to members of the Company increased 10.0% to $4,392 million;
- Business portfolio aligned to core capabilities;
- Share buy back; and
- Improving customer satisfaction.

National Australia Bank is about to commence the next phase of its development focused on creating sustainable satisfactory shareholder value.

The progress made in all parts of the Group during the past year was very pleasing. All of our key businesses are gaining momentum. Our portfolio is now well suited to our core capabilities and has the ability to produce sustainable growth in shareholder value.

Net profit attributable to members of the Company was up 10.0% to $4,392 million. This was affected by significant items, largely in respect of the UK pension reforms in 2006 and profit on the sale of the Irish Banks and restructuring provisions in 2005. This was all a part of getting the National Australia Bank match fit .

In 2006, net profit attributable to members of the Company before significant items was up 25.3% to $4,154 million. This is a better reflection of the underlying performance of the Group, but was also affected by the introduction of the Australian equivalents to International Financial Reporting Standards.

In line with our commitment to active capital management we will undertake a $500 million on-market share buy back to commence in the first half of 2007. We intend to neutralise the capital impact of shares issued under the dividend reinvestment plan and various employee share plans by either buying back shares issued or purchasing shares on market to satisfy our obligations rather than issuing new shares.

We have carefully managed margins, asset quality remains sound overall and we continued to strive to improve customer satisfaction levels throughout the Group.

The Corporate Centre was reduced in size and is focused on creating value for shareholders, strategic development of our portfolio of businesses, financial and risk performance and governance, developing and retaining talent and capital and balance sheet management.

The establishment of a regional business model has created a more nimble, customer-focused organisation in the regions in which we operate.

In the Australian business, we developed and launched new products, built market share in target areas and managed expenses.

As the major business within our portfolio, Australia also faced the largest challenge in the turnaround and made progress on all fronts.

This was reflected in the increase of 27.0% in net profit attributable to members of the Company to $2,515 million and excluding significant items, was up 10.9%.

In New Zealand, despite challenging economic conditions and fierce competition, our Bank of New Zealand operation performed well. Using the Unbeatable home loan campaign to position itself in a crowded market, net profit attributable to members of the Company increased 26.7% to $389 million and excluding significant items, was up 22.7%.

The United Kingdom operation differentiates National Australia Bank from other Australian banks. The net profit attributable to members of the Company of $868 million, a decrease of 46.7% (largely related to the profit on sale of the Irish Banks in 2005), represents 19.8% of overall Group net profit. Net profit attributable to members of the Company, excluding significant items, was up 15.7% to $618 million.

We successfully worked to rejuvenate the existing branch network, and expand into the southeast of England with Financial Solutions Centres targeting small to medium enterprises, and the mass affluent personal sector.

nabCapital, formerly Institutional Markets and Services increased net profit attributable to members of the Company by 22.9% to $618 million and excluding significant items was up 8.0%, while reducing the amount of capital deployed in the business. nabCapital further evolved its originate warehouse and distribute business model to provide greater linkage between the various parts of its business, and both borrowers and investors.

During the year we continued to develop the Corporate Social Responsibility (CSR) program within our businesses. Paying attention to broader social and environmental issues helps manage risks and identify new opportunities that add value to our business for shareholders and the communities in which we operate. This year we will produce our third CSR Report to outline our progress in this area.

I would like to thank the Board for its support, especially in leading the culture change program. A great deal of practical work has been completed to support the new Corporate Principles and measure behaviours. Over time, I am confident this will result in a fundamental and lasting shift in the culture.

And finally, thank you to all of our staff who worked very hard to contribute towards the National Australia Bank s success in 2006.

/s/ John Stewart

John Stewart
Group Chief Executive Officer

*Refer to non-GAAP measures on page 56 for an explanation of the Group s non-GAAP measures, including significant items, and reconciliations of non-GAAP financial measures , including significant items on page 7.*

**Presentation of information**

***Basis of presentation***

**This annual financial report is prepared in accordance with Australian equivalents to International Financial Reporting Standards (AIFRS) which differ in some respects from US GAAP *(as set out in note 57 in the financial report)*. Comparative amounts have been reclassified to accord with changes in presentation made in 2006, except where otherwise stated.**

**This is the Group s first annual financial report prepared in accordance with AIFRS. The 2005 annual financial report was prepared in accordance with previous Australian Generally Accepted Accounting Principles (AGAAP), which differs from AIFRS in certain respects *(as set out in note 1 in the financial report*).**

**This annual financial report does not include all of the requirements of the United States Securities and Exchange Commission (SEC) for an annual report on Form 20-F and will not be filed with the SEC as an annual report on Form 20-F. A separate annual report will be prepared and filed with the SEC on Form 20-F.**

***Currency of presentation***

All currency amounts are expressed in Australian dollars unless otherwise stated. Merely for the convenience of the reader, this annual financial report contains translations of certain Australian dollar amounts into US dollars at specified rates. These translations should not be construed as representations that the Australian dollar amounts actually represent such US dollar amounts or could be converted into US dollars at the rate indicated. Unless otherwise stated, the translations of Australian dollars into US dollars have been made at the rate of US$0.7461 = A$1.00, the noon buying rate in New York City for cable transfers in Australian dollars as certified for customs purposes by the Federal Reserve Bank of New York (noon buying rate) on September 30, 2006.

***Certain definitions and glossary***

The Company s fiscal year ends on September 30. The fiscal year ended September 30, 2006 is referred to as 2006 and other fiscal years are referred to in a corresponding manner. The abbreviations $m and $bn represent millions and thousands of millions (ie. billions) of Australian dollars respectively. Any discrepancies between total and sums of components in tables contained in this annual financial report are due to rounding.

A glossary of some of the key terms used in this annual financial report is contained at page 285. In addition, non-GAAP financial measures have been defined at page 56.

**Forward-looking statements**

This annual financial report contains certain forward-looking statements within the meaning of section 21E of the United States *Securities Exchange Act of 1934*. The United States *Private Securities Litigation Reform Act of 1995* provides a safe harbour for forward-looking information to encourage companies to provide prospective information about themselves without fear of litigation, so long as the information is identified as forward-looking and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the information.

Accordingly, the words anticipate, believe, expect, project, estimate, intend, should, could, may, target, goal, objective, plan, outlook and other similar expressions are used in connection with forward-looking statements.

In this annual financial report, forward-looking statements may, without limitation, relate to statements regarding:

economic and financial forecasts, including but not limited to statements in the financial review and the report of the directors;

anticipated implementation of certain control systems and programs, including, but not limited to those described in risk management; and

certain plans, strategies and objectives of management.

Such forward-looking statements are not guarantees of future performance and involve known and unknown risks, uncertainties and other factors, many of which are beyond the control of the Group, that may cause actual results to differ materially from those expressed in the statements contained in this annual financial report. For example:

the economic and financial forecasts contained in this annual financial report will be affected by movements in interest and foreign currency exchange rates, which may vary significantly from current levels, as well as by general economic conditions in each of the Group s major markets. Such variations may materially impact the Group s financial condition and results of operations;

the implementation of control systems and programs will be dependent on such factors as the Group s ability to acquire or develop necessary technology or systems, its ability to attract and retain qualified personnel and the response of customers and third parties such as vendors; and

the plans, strategies and objectives of management will be subject to, among other things, government regulation, which may change at any time and over which the Group has no control. In addition, the Group will continue to be affected by general economic conditions in Australia and worldwide, movements and conditions in capital markets, the competitive environment in each of its markets and political and regulatory policies.

There can be no assurance that actual outcomes will not differ materially from the forward-looking statements contained in this annual financial report.

**Selected financial data**

The information hereunder has been derived from the audited financial report of the Group, or where certain items are not shown in the Group s financial report, it has been prepared for the purpose of this annual financial report. Accordingly, this information should be read in conjunction with and is qualified in its entirety by reference to the financial report.

| | | Group | |
|---|---|---|---|
| | **2006 $m** | **2006 (1) US$m** | **2005 $m** |
| **Income statement summary** | | | |
| Net interest income | **8,686** | **6,481** | 6,944 |
| Net life insurance income | **1,417** | **1,057** | 1,505 |
| Gains less losses on financial instruments at fair value | **471** | **351** | 639 |
| Other income *(2)* | **4,615** | **3,443** | 5,251 |
| Significant revenue | **334** | **249** | 1,354 |
| | | | |
| Operating expenses *(3)* | **(7,642)** | **(5,702)** | (7,995) |
| Charge to provide for doubtful debts | **(606)** | **(452)** | (534) |
| Significant expenses | | | (748) |
| **Profit before income tax expense** | **7,275** | **5,428** | 6,416 |
| Income tax expense | **(2,134)** | **(1,592)** | (1,814) |
| **Net profit** | **5,141** | **3,836** | 4,602 |
| Net profit attributable to minority interest | **(749)** | **(559)** | (610) |
| **Net profit attributable to members of the Company** | **4,392** | **3,277** | 3,992 |
| Dividends paid/payable *(4)* | **2,554** | **1,905** | 2,454 |

| | | Group | |
|---|---|---|---|
| | **2006 $m** | **2006 (1) US$m** | **2005 $m** |
| **Balance sheet summary** | | | |
| Investments relating to life insurance business | **54,784** | **40,874** | 49,783 |
| Loans and advances | **283,777** | **211,726** | 264,674 |
| Total assets | **484,785** | **361,698** | 422,598 |
| Total risk-weighted assets *(5)* | **318,323** | **237,501** | 289,833 |
| | | | |
| Deposits and other borrowings | **222,277** | **165,841** | 212,557 |
| Life policy liabilities | **46,475** | **34,675** | 42,123 |
| Bonds, notes and subordinated debt | **65,006** | **48,501** | 41,490 |
| Other debt issues | **2,274** | **1,697** | 1,559 |
| Net assets | **27,972** | **20,870** | 31,547 |
| | | | |
| Contributed equity | **12,279** | **9,161** | 10,828 |
| Ordinary shares | **7,948** | **5,930** | 6,894 |
| Other equity instruments *(6)* | **4,331** | **3,231** | 3,934 |
| Total equity (excludes minority interest) | **27,804** | **20,745** | 25,323 |

| | Group | | |
|---|---|---|---|
| | **2006 $** | **2006 (1) US$** | **2005 $** |
| **Shareholder information** | | | |
| Earnings per share *(7)* | | | |
| Basic | **2.63** | **1.96** | 2.46 |
| Diluted | **2.62** | **1.95** | 2.42 |
| Dividends per share *(4)* | **1.67** | **1.25** | 1.66 |
| Dividends per American depositary share (ADS) *(4)* | **8.35** | **6.23** | 8.30 |
| Dividend payout ratio (%) *(4)* | **67.35** | **67.35** | 79.56 |
| Net assets per share | **17.38** | **12.97** | 20.13 |
| Share price at year end | **36.70** | **27.38** | 33.05 |
| Number of ordinary shares at year end (No. 000) | **1,610,288** | **n/a** | 1,567,654 |

| | Group | |
|---|---|---|
| | **2006 %** | **2005 %** |
| **Selected financial ratios** | | |
| Average equity (ordinary shareholder funds) to average total assets (excluding statutory funds) *(8) (9)* | **5.4** | 5.5 |
| Return on average assets *(10)* | **0.9** | 0.9 |
| Return on average equity (ordinary shareholder funds) *(9) (10)* | **18.8** | 18.0 |
| Average net interest spread | **1.88** | 1.69 |
| Average net interest margin | **2.31** | 2.13 |
| Gross impaired assets to gross loans and acceptances *(11)* | **0.30** | 0.35 |
| Net impaired assets to equity (parent entity interest) | **3.1** | 2.8 |
| Total provisions for doubtful debts to gross impaired assets | **191.3** | 235.8 |
| Capital risk asset ratios *(12)* | | |
| Tier 1 | **7.3** | 7.9 |
| Tier 2 | **3.9** | 3.6 |
| Deductions | **(0.4)** | (1.0) |
| Total | **10.8** | 10.5 |

**US GAAP measures**

| | Group | | | | | |
|---|---|---|---|---|---|---|
| | **2006 $m** | **2006 (1) US$m** | **2005 $m** | **2004 $m** | **2003 $m** | **2002 $m** |
| **Selected financial data in accordance with US GAAP** | | | | | | |
| Net income | **4,232** | **3,157** | 3,891 | 2,781 | 3,667 | 3,455 |
| Total assets | **485,728** | **362,402** | 424,628 | 417,758 | 398,448 | 380,280 |
| Total equity | **25,911** | **19,332** | 23,385 | 23,311 | 22,297 | 24,005 |

| | **2006 $** | **2006 (1) US$** | **2005 $** | **2004 $** | **2003 $** | **2002 $** |
|---|---|---|---|---|---|---|
| **Selected shareholder information in accordance with US GAAP** | | | | | | |
| Net income per share *(7)* | | | | | | |
| Basic | **2.60** | **1.94** | 2.44 | 1.71 | 2.30 | 2.11 |
| Diluted | **2.57** | **1.92** | 2.40 | 1.71 | 2.22 | 2.06 |
| Dividends per ADS (US$) *(4) (13)* | **n/a** | **n/a** | 6.09 | 6.13 | 6.03 | 4.12 |
| Dividends as percentage of net income (%) | **63.48** | **63.48** | 67.45 | 89.78 | 64.14 | 65.59 |

| | 2006<br>% | 2005<br>% | 2004<br>% | 2003<br>% | 2002<br>% |
|---|---|---|---|---|---|
| **Selected financial ratios in accordance with US GAAP** | | | | | |
| Net income as a percentage of | | | | | |
| Average total assets (excluding statutory funds) *(8)* | **1.1** | 1.0 | 0.8 | 1.0 | 1.0 |
| Average equity | **17.2** | 16.7 | 12.2 | 15.8 | 14.5 |
| Total equity as percentage of total assets (excluding statutory funds) *(8)* | **6.0** | 6.3 | 6.2 | 6.2 | 6.9 |

| | Group | |
|---|---|---|
| | 2006 $m | 2005 $m |
| **Reconciliations of non-GAAP measures** ***(14)*** | | |
| **Net profit attributable to members of the Company** | **4,392** | 3,992 |
| Adjusted for | | |
| Significant revenue | **(334)** | (1,354) |
| Significant expenses | | 748 |
| Income tax expense/(benefit) on significant items | **96** | (72) |
| **Net profit attributable to members of the Company before significant items** | **4,154** | 3,314 |
| | | |
| **Net profit to cash earnings before significant items reconciliation** | | |
| Net profit attributable to members of the Company | **4,392** | 3,992 |
| Adjusted for | | |
| Net profit/(loss) attributable to minority interest | **749** | 610 |
| Net profit | **5,141** | 4,602 |
| Adjusted for | | |
| Net (profit)/loss attributable to minority interest | **(749)** | (610) |
| Distributions on other equity instruments | **(254)** | (204) |
| Treasury shares (after-tax) | **126** | 143 |
| Investment earnings on shareholders retained profits and capital from life businesses discount rate variation | **6** | |
| Revaluation gains/(losses) on exchangeable capital units (after-tax) | **112** | |
| Net (profit)/loss on sale of controlled entities (after-tax) | **(108)** | |
| Economic hedge (gain) on proceeds from sale of controlled entities (after-tax) | **(22)** | |
| **Cash earnings** | **4,252** | 3,931 |
| Adjusted for | | |
| Significant revenue | **(402)** | (1,354) |
| Significant expenses | | 748 |
| Income tax expense/(benefit) on significant items | **117** | (72) |
| **Cash earnings before significant items** | **3,967** | 3,253 |
| | | |
| **Average ordinary shareholder funds reconciliation** | | |
| Total average equity *(refer to note 42 in the financial report)* | **26,016** | 28,806 |
| Adjusted for | | |
| National Income Securities (average) | **(1,945)** | (1,945) |
| Trust Preferred Securities (average) | **(975)** | (975) |
| Trust Preferred Securities II (average) | **(1,014)** | (531) |
| National Capital Instruments (average) | **(13)** | |
| Minority interest (average) | **(50)** | (4,281) |
| **Average ordinary shareholder funds** | **22,019** | 21,074 |

| | Group | | | | |
|---|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| **Employees** | | | | | |
| Full-time equivalent *(15)* | **38,433** | 38,933 | 43,517 | 42,540 | 43,202 |

| | | | Group | | |
|---|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| **Exchange rates (average and closing per A$1.00)** | | | | | |
| Average | | | | | |
| British pound | **0.4150** | 0.4141 | 0.4055 | 0.3824 | 0.3622 |
| United States dollar | **0.7467** | 0.7654 | 0.7265 | 0.6125 | 0.5324 |
| New Zealand dollar | **1.1432** | 1.0847 | 1.1254 | 1.1142 | 1.1992 |
| | | | | | |
| Closing | | | | | |
| British pound | **0.3991** | 0.4326 | 0.3973 | 0.4072 | 0.3474 |
| United States dollar | **0.7478** | 0.7617 | 0.7149 | 0.6804 | 0.5440 |
| New Zealand dollar | **1.1439** | 1.0991 | 1.0682 | 1.1446 | 1.1565 |

| | | | Group | | |
|---|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2003 | 2002 |
| **United States dollar (per A$1.00)** | | | | | |
| Average *(16)* | **0.7468** | 0.7655 | 0.7263 | 0.6167 | 0.5329 |
| September 30 | **0.7461** | 0.7643 | 0.7244 | 0.6797 | 0.5628 |

On November 10, 2006 the noon buying rate was US$0.7673 per A$1.00.

| | | | Group 2006 | | | |
|---|---|---|---|---|---|---|
| | November | October | September | August | July | June |
| **United States dollar (per A$1.00)** | | | | | | |
| High | 0.7837 | 0.7738 | 0.7713 | 0.7677 | 0.7675 | 0.7522 |
| Low | 0.7619 | 0.7421 | 0.7459 | 0.7573 | 0.7419 | 0.7293 |

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*(1)* *Translated at the noon buying rate on September 30, 2006 of US$0.7461 = A$1.00.*

*(2)* *In 2006, other income includes the net profit (before-tax) from the sale of the Custom Fleet business.*

*(3)* *In 2006, operating expenses includes the net loss (before-tax) from the sale of the MLC Asia businesses.*

*(4)* *Dividend amounts for a year represent the final and interim dividend in respect of that year, irrespective of when they are declared, determined and publicly recommended and includes issues under the bonus share plan in lieu of cash and the dividend reinvestment plan. Dividends and book value per ordinary share and per American depositary share (ADS) calculations are based on year-end fully paid equivalent ordinary shares, adjusted for loans and rights issues as appropriate. Dividend payout ratio is the dividend amounts for a year divided by cash earnings before significant items. Refer to page 7 for a reconciliation of cash earnings before significant items and page 56 for an explanation of non-GAAP financial measures .*

*(5)* *The calculation to determine the market risk capital component of risk-weighted assets at September 30, 2006 and September 30, 2005 was carried out under the Standard Method as directed by APRA. The Standard Method as prescribed by the APRA Prudential Standard (APS 113), limits recognition of portfolio effects on outstanding positions and is substantially more restrictive on the rules regarding the matching of positions.*

*(6)* *Equity instruments comprise preference shares, National Income Securities, Trust Preferred Securities, Trust Preferred Securities II and National Capital Instruments.*

*(7)* *Refer to notes 8 and 57 in the financial report for an explanation of earnings per share.*

*(8)* *Statutory funds are excluded given the significant restrictions imposed on these assets by life insurance legislation, regulations and the regulators thereunder. However, current Australian accounting requirements do not allow for these assets and liabilities to be separated and disclosed separately on the balance sheet.*

(9) *Refer to page 7 for a reconciliation of average ordinary shareholder funds.*

(10) *Return represents net profit attributable to members of the Company after deducting distributions on other equity instruments.*

(11) *In 2006, this includes loans accounted for at fair value.*

(12) *As defined by APRA (refer to liquidity, funding and capital resources on page 27).*

(13) *Dividend amounts are translated into US dollars per ADS (representing five fully paid ordinary shares) at the exchange rate on each of the respective payment dates for interim and final dividends. The 2006 final dividend of $0.84 per ordinary share is not payable until December 12, 2006. Accordingly, the total US dollar dividend per ADS for 2006 cannot be determined until that date.*

(14) *Refer to page 56 for explanations of non-GAAP financial measures .*

(15) *Full-time equivalent employees (FTEs) includes part-time staff (pro-rated) and non-payroll FTEs (ie. contractors).*

(16) *The daily average of the noon buying rates.*

**Business overview**

**Introduction**

The Group is an international financial services group that provides a comprehensive and integrated range of financial products and services.

The Company traces its history back to the establishment of The National Bank of Australasia in 1858. National Australia Bank Limited is a public limited company, incorporated on June 23, 1893 in Australia, which is the Company s main domicile. Its registered office is 35th floor, 500 Bourke Street, Melbourne Victoria 3000, Australia. The Company operates under the requirements of the *Banking Act* 1959 (Cth) and the *Corporations Act* 2001 (Cth).

In 1981 the National Bank of Australasia merged with the Commercial Banking Corporation of Sydney which was established in 1834.

Globally, as at September 30, 2006, the Group had:

- total assets of $485 billion;
- $97 billion in assets under management and administration;
- $474 billion in funds under custody and investment administration; and
- 8.0 million banking and 2.3 million wealth management customers.

**Strategy and corporate principles**

The Group s corporate purpose is to generate sustainable satisfactory returns to shareholders.

The Group s strategies are focused on the turnaround of the Group and building new avenues for growth. There has been, and continues to be a focus on:

- re-invigorating the Group s franchise and brand;
- improving the Group s core infrastructure;
- accelerating cultural change around the Group s corporate principles;
- enhancing the Group s disciplined approach to performance improvement;
- improved regulatory and key stakeholder engagement;
- strengthening risk and capital management; and
- leveraging our distinctive capabilities to create new and differentiated growth opportunities.

The Group s corporate principles will continue to be embedded in the Group s culture to ensure that thinking and actions are aligned with the Group s strategic direction.

The five principles are:

- we will be open and honest;
- we take ownership and hold ourselves accountable (for all our actions);
- we expect teamwork and collaboration across our organisation for the benefit of all stakeholders;
- we treat everyone with fairness and respect; and
- we value speed, simplicity and efficient execution of our promises.

**Organisational structure and operating model**

National Australia Bank Limited is the holding company for the Group, as well as the main operating company. During 2006, the Company had four wholly-owned main operating subsidiaries: Bank of New Zealand, Clydesdale Bank PLC, MLC Limited and National Australia Financial Management Limited.

The Company continues to consider a range of options to optimise its domestic and international operations, including a non-operating holding company. The Company is participating in industry-wide consultation with regulators in the relation to the matter. Consideration of various structural options which involves a range of complex issues, the analysis and subsequent decision on a particular path are expected to take some time to complete.

During the 2006 year, two divestments occurred, the Custom Fleet and MLC Asia businesses. *For further information on these divestments refer to page 45 and page 46 respectively).*

In 2005, one significant divestment occurred. In February 2005, the Group sold the shares of National Europe Holdings (Ireland) Limited, the immediate parent entity of Northern Bank Limited and National Irish Bank Limited. *For further information on this divestment, refer to page 45.*

The business operating model is run along regional lines of business as follows:

- Australia Region  comprises Australian Banking and Wealth Management Australia;
- United Kingdom Region  comprises United Kingdom Banking and Wealth Management United Kingdom;
- New Zealand Region  comprises New Zealand Banking and Wealth Management New Zealand; and
- nabCapital (global).

This is supported by the Group s Other business segment, which includes streamlined functions that support all the regional businesses and comprises Group Funding and Corporate Centre activities.

The Group operates around 1,715 outlets and offices worldwide, of which 58% are in Australia, with the largest proportion of the remainder being in the UK. Approximately 12% of the 1,715 outlets and offices are owned directly by the Group, with the remainder being held under commercial leases.

*Refer to note 45 in the financial report for details of the principal controlled entities of the Group and note 21 for details of the Group s property, plant and equipment.*

**Australia Region**

The Australia Region of the Group provides a broad range of banking and wealth management products and services. As well as lending and deposit taking, Australia Region includes the Australian cards, custody and other transactional banking operations, as well as its wealth management activities including insurance, investments and superannuation, in both Australia and Asia. It does not include nabCapital s operations in Australia and Asia.

The Australia Region incorporates an extensive distribution network to service customers. At September 30, 2006, there were 85 integrated financial service centres (catering for customers financial advice needs), 186 business banking centres, 110 agribusiness locations, 27 private banking suites, 787 branches and agencies, and over 3,200 Australia Post GiroPost outlets.

Electronic distribution also provides customers with the choice to meet their financial needs via the internet, over the telephone, through more than 1,290 automatic teller machines (ATM) as at September 30, 2006, or through an extensive network of electronic funds transfer point of sale (EFTPOS) terminals. There were over 1.1 million registered internet banking customers at September 30, 2006.

At September 30, 2006, Australia Region had 22,411 full-time equivalent employees.

In 2005, four key strategies were focused upon:

- customer and employee satisfaction;
- simplifying our business through productivity, efficiency and quality gains;
- re-investing in our critical infrastructure; and
- managing our business units for performance.

Key achievements and actions taken during the 2006 year include:

- awarded Bank of the Year in Money Magazine s 2006 Consumer Finance Awards;
- MLC Insurance Limited awarded Insurance Company of the Year 2006 at the Australian and New Zealand Industry Awards;
- updated its brand in February 2006, supported by significant internal and external communications and sponsorship of the 2006 Commonwealth Games, the Socceroos and the Australian Football League;
- Customer First program a reconfiguration of the business and retail network - with rollout in Queensland completed;
- new and enhanced product offerings, which have delivered substantial revenue growth;
- stable net interest margin and overall risk quality;
- cross-selling of Wealth Management products in bank channels up 31% (investments), up 35% (insurance) and up 22% (debt products) in Wealth Management channels on the 2005 year;

sale of MLC Asia businesses and Custom Fleet business; and

the final review by an independent expert, PricewaterhouseCoopers, was conducted, following which APRA and ASIC jointly considered that all actions under the MLC enforceable undertakings and directions issued to the relevant MLC group companies are now complete.

Management also continues to drive significant cultural and behavioural change within Australia Region. Recent internal surveys have highlighted improvement in employees sharing a common vision and having clarity about what they need to do to help the region meet its goals and objectives. Importantly customer satisfaction improved significantly this year due to the region s commitment to improving the customer experience in the front line through branch refurbishment, service improvement and product innovation.

Five key themes will guide effort over the next few years:

improving process quality to increase customer satisfaction and lower costs;

reducing enterprise costs;

extending customer relationships, to grow revenue, especially cross-selling;

renewing infrastructure; and

creating a distinctive NAB way of working and leading.

Commentary on each of the divisions of the Australia Region is provided below.

**Business and Private Banking**

The Business and Private Banking operation provides lending, deposit, transaction and specialist services to over 1 million customers, including businesses and high net worth individuals in Australia.

During the 2006 year Business and Private Banking implemented a new operating model bringing together both the product management and distribution management aspects of the business. This change has been instrumental in ensuring a consolidation of the turnaround performance of last year and has enabled a continuation of focused sales campaigns, improved product offerings (eg, Business Options, Business Cash Maximiser and the Portfolio Facility) and increased capacity for our people.

The Company continues to be Australia s largest business lender with a market share of 19.0% (source: RBA financial system, company data, September 2006), and largest business deposit-taker with a market share of over 24.9% (source: APRA banking system, company data, September 2006). The business is underpinned by an extensive distribution network and excellent business bankers. Improvement in processes has led to improved client service and the capacity release for future growth. Emphasis has been on training to ensure the business has strong credit skills and are able to provide value to clients. Growth has also been underpinned by an embedded performance management framework aligned to the Group s corporate principles.

Management are continuing to improve the service and support offered to business customers with the ongoing development of a new business internet banking platform - the foundation release is currently in use with upcoming releases in the first quarter of 2007.

Other key focus areas include the ongoing refinement of the relationship management model, reinforcing sales capability, customer retention, growing deposits, cross-sales and industry specialisation.

**Retail Banking**

Retail Banking provides lending, deposit and transaction services to approximately 3.2 million retail customers through extensive physical and virtual distribution networks.

The key areas of focus for Retail Banking during the year have been the re-invigoration of the sales channel and product innovation.

The re-invigoration of the retail distribution sales channel has resulted in significant change at the front line. These efforts have concentrated on improving branch sales capability, empowering front line staff and enhancing the customer experience.

A local market operating model was established during the year, with newly appointed regional executives having financial accountability for their local area. Other key initiatives included a realignment of the mobile banker channel, rollout of a new customer segmentation model and branch refurbishment program. This has increased branch home loan sales capability. The refurbishment of 198 branches was completed by September 30, 2006.

As competitive pressure has continued to characterise the external operating environment, product innovation has been another important area of focus. New products launched during the year have included the Velocity Card, Low Rate Visa Card, Custom Home Loan and the NAB Investment Cash Manager. Coupled with new products launched toward the end of the 2005 year (high-yield internet savings account and the Personal Project Loan), these product developments continue to enhance the Group s product offerings and improve sales through targeted campaigns.

**Wealth Management**

Under the MLC brand, Wealth Management provides investment, superannuation and insurance solutions to 1.9 million retail and corporate customers. As at September 30, 2006, Wealth Management managed approximately $94 billion on behalf of its customers.

Wealth Management s Financial Planning and Third Party division manages relationships with its network of salaried, self-employed aligned and external financial planners, as well as mortgage brokers. The division provides a range of tools and support services to financial planners and mortgage brokers including practice management support, financial planning software, and business growth and efficiency support.

Wealth Management has more than 1,300 aligned and salaried advisers and relationships with more than 1,200 external advisers at September 30, 2006. At the same time, it has relationships with approximately 12,200 brokers.

In its core Australian market, as at June 30, 2006, MLC held the largest share of total individual risk business with a 15.0% share of inforce annual premiums (source: DEXX&R Life Analysis Report, date: June 30, 2006). At the same time, it was ranked number one in market share of master trusts, with a 15.5% market share of funds under management (source: Plan for Life Australian Retail & Wholesale Investments Market Share & Dynamics Report, date: June 30, 2006).

Focus on the utilisation of the regional model to promote business strategies and deliver improved outcomes for customers continued throughout 2006. Product initiatives in 2006 included:

Masterkey Fundamentals, a no commission version of our MasterKey platform, supporting a growing number of advisers operating under a fee for service model;

MLC Long Term Absolute Return (LTAR) Fund, which is an unconventional investment strategy explicitly designed to maximise the long term net real return to investors over rolling 20-year time frames;

two JANA retail investment trusts; and

MLC EasyCover, a debt insurance solution purpose-built for mortgage brokers.

Wealth Management completed its regulatory undertakings to the Australian Securities and Investments Commission (ASIC) and Australian Prudential Regulation Authority (APRA) and also completed the compensation program for investors in a number of products that were adversely affected by October 2001 unit pricing reductions, as well as two associated historical unit pricing errors.

**Asia**

The Australia Region is also responsible for the Group s banking and wealth management activities in Asia. In May 2006, the Wealth businesses in Hong Kong and Indonesia were sold to AXA Asia Pacific. The remaining businesses have been consolidated with Hong Kong as the primary base supporting both the Tokyo and Singapore branches. The business commenced a strategic alliance with China Union Pay which claims to have up to 99% of the credit and debit card market in China. Chinese visitors to Australia will have access at NAB ATMs and EFTPOS terminals.

*Refer to page 35 for detailed information of the financial performance of the Australia Region.*

**United Kingdom Region**

United Kingdom Region (UK), consists of banking and wealth management activities in the UK that provide financial solutions to approximately 3.1 million customers in the UK. It includes nabCapital s operations in the UK. At September 30, 2006, UK had 8,822 full-time equivalent employees.

The Group s activities in the UK operate under two brands, Clydesdale Bank and Yorkshire Bank, within one legal entity, Clydesdale Bank PLC.

Clydesdale Bank was established in 1838 in Glasgow, has a long history of support for Scottish industries and communities, and has been part of the Group since 1987. Clydesdale Bank is one of Scotland s largest retail banks, as well as one of the country s leading business banks. In the 2006 year, Clydesdale Bank has continued to expand its network of Financial Solutions Centres in the south of England.

Yorkshire Bank was founded in 1859 in Halifax, West Yorkshire, and today maintains a strong regional focus in the north of England and the Midlands. Yorkshire Bank has a strong personal customer base and business capability, and has been part of the Group since 1990.

Each bank offers a broad range of financial products and services to both retail and business customers. Products and services provided by Wealth Management and nabCapital offer customers a further range of financial solutions.

Following the sale of Northern Bank Limited and National Irish Bank Limited to Danske Bank A/S in February 2005, the Group provided transitional services to Danske Bank A/S in respect of the Northern Bank Limited and National Irish Bank Limited operations to assist in the transition of ownership of those businesses. These transitional services were provided at cost and ended in April 2006. Subsequently, any ongoing services provided to Danske Bank A/S have been on commercial business terms.

In the 2005 year, the Group recorded a provision of $266 million to cover costs of restructuring initiatives including the streamlining of operations, reductions in staffing levels and the reconfiguration of its distribution networks. It was anticipated that the restructuring would lead to a total reduction of approximately 1,700 positions across the UK over a 12-to-18 month period, together with the closure of approximately 60 Clydesdale Bank branches and 40 Yorkshire Bank branches. This decision reflected the changing needs of customers and the different ways in which they are banking. The branch closure programme was completed in March 2006, six months ahead of schedule, with a total of 105 branches closed and 99% of the reduced staffing positions being achieved by September 30, 2006.

At September 30, 2006, the Group s UK distribution network comprised 153 Clydesdale Bank branches, 190 Yorkshire Bank branches and 74 Financial Solutions Centres, supported by 2 customer contact centres, internet banking, telephone banking and 921 ATMs.

During the 2006 year, a further 6 Financial Solutions Centres were opened in the south and, as at September 30, 2006, there were 38 centres operating in Scotland and the north of England and 36 centres operating in the south of England. Financial Solutions Centres offer integrated business and private banking services to small-medium sized business customers.

In the retail distribution network, the branch network rationalisation has been completed and other locations with potential have been reinforced with investment in flagship branches, which handle micro businesses as well as retail customers.

Further expansion into the mortgage intermediary market continued with the marketing of Clydesdale Bank branded mortgage products through third party distributors. As at September 30, 2006, more than 450 broker relationships have been established.

In July 2006, Clydesdale Bank established an offshore branch banking operation in Guernsey, initially taking deposits with plans to expand the range of services offered.

Further progress has been made toward centralising, streamlining and simplifying technology and operations. Customer Connect , which is the Bank s sales and service illustration tool, has been rolled out to all Yorkshire branches and a new teller system is now successfully operating in over half of those branches. The programme of process simplification and workload removal has continued with greater process and transaction centralisation. In addition, the processing of third party originated mortgages and procurement was outsourced during the year.

Rationalisation of products continues with a planned reduction in product numbers over the next 12-18 months. New base rate tracker mortgage and savings products and offshore deposit products have been launched to enhance our product offerings.

Major pension reforms were implemented during the 2006 year following consultations with staff, unions and pension fund trustees, including a ballot of employees to seek their agreement to the revised benefits. This has resulted in the three defined benefit schemes moving from final salary to a career average structure for benefits accrued from April 1, 2006. As part of the reforms, the Group made a one-off contribution across the defined benefit schemes during the 2006 year and improvements were made to the defined contribution scheme.

Attention has also been directed to further develop talent and the quality of leadership. A branch development programme has been undertaken with more than 200 senior retail staff to enhance leadership skills in areas such as coaching, mentoring and performance management.

*Refer to page 36 for detailed information of the financial performance of United Kingdom Region.*

**New Zealand Region**

New Zealand (NZ) Region consists of NZ Banking and Wealth Management activities, and at September 30, 2006 had 4,505 full-time equivalent employees. It does not include nabCapital s operations in New Zealand.

NZ Banking represents the retail and business banking arm of the Group in NZ, which together with nabCapital operates under the Bank of New Zealand (BNZ) brand. Custom Fleet s operations in NZ were also part of NZ Banking until they were sold on July 31, 2006. NZ Banking provides financial solutions for 1.1 million customers at September 30, 2006 and is the primary contributor of the NZ financial result. The Investment Management arm of the Wealth Management operations was sold during January 2006.

BNZ, acquired by the Group in 1992, is one of the largest financial service providers in NZ and has a strong brand position with comprehensive coverage in a very competitive market.

BNZ has strong market share positions in business, corporate, agribusiness and cards. A major component of BNZ s longer-term strategy is also to drive growth in key personal market segments of housing, small-medium enterprises and youth.

BNZ continued its strong programme of re-investing in its people, products and infrastructure which is reflected in gains in customer satisfaction and brand awareness, and BNZ winning domestic and international awards for its Customer Contact Centres.

Focus on people development, performance and customers, and the ongoing enhancement of the physical distribution network, coupled with improved technology, automation and functionality through electronic and remote channels, continue to be core to the strategy. This, together with the strategic decision to discontinue the mortgage broker distribution channel, reflects BNZ s vision to empower its customers with a range of convenient and cost-effective channels.

The distribution network at September 30, 2006 comprised of 180 outlets, 402 ATMs, and shared access to an extensive nationwide EFTPOS network. BNZ also has well-established telephone banking capabilities, in addition to its internet banking service catering for more than 310,000 registered users as at September 30, 2006.

*Refer to page 37 for detailed information of the financial performance of New Zealand Region.*

**nabCapital (formerly Institutional Markets & Services)**

nabCapital is a global business with operations in Australia, the United Kingdom, New Zealand, United States and Asia. At September 30, 2006, it had 2,075 full-time equivalent employees. nabCapital provides debt financing, financial risk management and investor services and products to the Group s customers, and trades financial risk management products. It is also responsible for the management of relationships with top tier corporate clients and financial institutions.

In July 2006, the business was reorganised to establish two global business lines Global Markets and Structuring & Investments - and three regionally focused businesses, Australia (including Asia and the US), the United Kingdom and New Zealand.

Global Markets is focused on traded products and financial risk management solutions. It provides foreign exchange, money market, commodities and derivatives products globally through a dedicated 24-hour dealing capability. Structuring & Investments is responsible for manufacturing investment products and managing nabCapital s assets. The three regions are responsible for managing the franchise and customer relationships, including the provision of corporate finance products and services such as project finance and leveraged finance.

The reorganisation of the business ensures nabCapital s structure aligns to its operating model of originating a more diverse mix of funding and risk management products, repackaging or warehousing the risk around those products, and distributing them to a larger pool of investors. This has helped nabCapital maintain its strong position in Australian bonds, loan syndications and project finance league tables (source: Thomson Financial and Dealogic), and saw positive movement in client satisfaction measures.

A strong emphasis on remediation work remains as the business continues towards obtaining internal model re-accreditation for its Market Risk systems from APRA. The cultural change agenda continues with two-thirds of nabCapital employees participating in a cultural diagnostic which is helping to shape the next steps in the cultural development of nabCapital. In addition, nabCapital has initiated a three year Strategic Investment Program aimed at delivering a simplified, flexible, and cost effective business and technology platform to support its growth initiatives.

The move during the year to a new name and a distinct brand identity reflects more accurately the nature of the business. The new branding applies to nabCapital s global operations except in New Zealand, where it continues to operate under the Bank of New Zealand brand.

*Refer to page 38 for detailed information of the financial performance of nabCapital.*

**Other**

The Group s Other business segment includes streamlined functions that support all the regional businesses and comprises Group Funding and Corporate Centre activities. Group Funding acts as the central vehicle for movements of capital and structural funding to support the Group s operations. Corporate Centre activities include strategic development of the portfolio of businesses, financial and risk governance, developing and retaining talent, capital and balance sheet management.

**Employees**

The following tables summarise the Group s staffing position as at September 30:

| | 2006 Number | 2005 Number | 2004 Number |
|---|---|---|---|
| **By geographic region** | | | |
| Australia | **24,263** | 23,554 | 24,567 |
| Europe | **9,197** | 9,868 | 13,324 |
| New Zealand | **4,686** | 4,814 | 4,766 |
| United States | **93** | 114 | 141 |
| Asia | **194** | 583 | 719 |
| Total full-time equivalents *(1)* | **38,433** | 38,933 | 43,517 |

| | 2006 Number | 2005 Number | 2004 Number |
|---|---|---|---|
| **By line of business** | | | |
| Australia Region | **22,411** | 22,136 | 23,128 |
| United Kingdom Region | **8,822** | 9,480 | 12,865 |
| New Zealand Region | **4,505** | 4,645 | 4,596 |
| nabCapital | **2,075** | 1,993 | 2,073 |
| Other | **620** | 679 | 855 |
| Total full-time equivalents *(1)* | **38,433** | 38,933 | 43,517 |

*(1) Full-time equivalent employees (FTEs) includes part-time (pro-rated) and non-payroll FTEs (ie. contractors).*

The Group s full-time equivalent (FTE) employee numbers decreased by 500 or 1.3% to 38,433 during the 2006 year. This decrease primarily reflects the following:

the sale of the Group s Custom Fleet and MLC Asia businesses which reduced FTE by 923;

restructuring activities, particularly in Australia and the United Kingdom, which decreased FTE by 1,654; partly offset by

the uplift associated with projects and business initiatives, which increased FTE by 1,815.

The Group s FTE employee numbers decreased by 4,584 or 10.5% to 38,933 during the 2005 year. This decrease primarily reflected the following:

the sale of Northern Bank Limited and National Irish Bank Limited, which had 2,712 FTE at September 30, 2004; and

the significant restructure, reorganisation and integration of all of the Group s businesses, particularly in the Australia, United Kingdom and nabCapital segments, amounting to a reduction of 1,964 FTE.

*Refer to page 47 for further information on the Group s restructuring expenses and provisions recorded by the Company during the 2005 year.*

The Group continues to work professionally and constructively with the unions in Australia, United Kingdom, New Zealand and in other countries where the Group operates, recognising their members as key stakeholders in the organisation. The Group utilises a number of industrial instruments including individually negotiated contracts and collective agreements.

In Australia, there is a single enterprise agreement, which comprises the terms and conditions for all employees. This agreement was developed and negotiated with the Finance Sector Union and was certified in

February 2006. The agreement replaced all previous agreements and some site agreements to provide a single consolidated version for Australian employees. The agreement runs from 2006 to 2009 and provides for a total of 4% pay increase each year for all employees, excluding those on management levels.

Bank of New Zealand has a collective agreement covering the branch network, contact centres and back-office locations. This collective agreement was renegotiated with FinSec late in calender 2005 and runs from November 2005 to October 2007. A pay increase of 4.35% was paid to these employees in November 2005, with a further 4% to be paid in November 2006.

Pay negotiations commenced with the UK union, Amicus, during November 2005. A single negotiation process replaced the three separate pay negotiations previously conducted annually. A pool of 3.3% was paid to these employees with a further 0.1% available for lower paid employees.

*For further information on the remuneration and reward policies offered by the Group, refer to the remuneration report on pages 78 to 93 of this annual financial report and note 41 shares, performance options and performance rights and note 52 equity instrument holdings of key management personnel in the financial report.*

**Economic outlook**

This section contains forward-looking statements. *Refer to forward-looking statements on page 4.*

Global economic conditions remained strong in 2006. While the US expansion has begun to moderate, China and more generally developing economies performed very strongly. In addition Japanese activity picked up significantly and the Euro area has improved.

Business conditions in the countries that contain the bulk of the Group s assets remained solid but varied by regions and sectors. In New Zealand, slow growth emerged as households adjusted to higher interest rates and cooling property markets. Australian activity remained strong and unemployment levels continue to fall. Resource and related sectors and regions were boosted by high commodity prices, while conditions moderated in retail and manufacturing sectors. UK activity picked up with contributions from both household spending and business investment.

The global growth outlook is for a moderation in activity in 2007. The normalising of interest rates and continued high oil prices are expected to continue to slow the pace of the current global expansion. Growth is also expected to be sustained in the Group s main operating regions. In Australia, some moderation in domestic spending is expected. The drought and slower domestic demand is expected to impact growth. Faced with capacity and inflationary pressures, New Zealand looks set to sustain slow growth in domestic spending. In the UK, growth is expected to remain reasonable with a strong services sector but a weak manufacturing sector.

The Group s main areas of operation continue to face similar economic risks and vulnerabilities. External imbalances and already stretched fiscal positions especially in the US and Europe might limit any response to any increased geopolitical tensions. Any disruption to the current strong growth in China and other emerging economies would also be expected to lead to a marked revaluation of global income growth and asset prices. On the other hand, overly aggressive action by central banks in response to inflation pressures could also trigger negative wealth effects and a marked slowdown in household spending.

**Competition**

The Australian financial system is characterised by intense competition from a large number of traditional and new players, and well-developed equity and corporate bond markets. There are four major national banks and many other financial conglomerates with national operations offering a complete range of financial services, as well as a number of smaller regional institutions and niche players. Non-bank financial institutions are a force in the Australian financial system, although many have demutualised over the past decade to capture capital-related and other competitive advantages. Non-bank financial institutions offer a wide portfolio of products and services including insurance, investments and superannuation (pensions).

Competition also comes from numerous Australian and, in many cases, international non-bank financial intermediaries including investment and merchant banks, specialist retail and wholesale fund managers, building societies, credit unions and finance companies. Product and functional specialists operate and are important players in the household and business mortgage, credit card deposit and other payment services markets. The rapid development and acceptance of the internet and other technologies have increased competition in the financial services market and improved choice and convenience for customers.

These forces are evident across all of the Group s businesses in each of its geographic markets. Within the broader financial services industry, increased competition has led to a reduction in operating margin, partly offset by fees and other non-interest income and increased efficiencies. The latter has been largely achieved through greater investment in new technologies for processing, manufacturing and retailing products and services. These trends towards increasingly contestable markets offering improved access, wider choice and lower prices for customers are expected to continue in the future.

**Risk management**

**Introduction**

Effective management of risk is a key capability for a successful financial services provider, and is fundamental to the Group s strategy. A key component of the Group s risk management strategy is the establishment by the Board of a formal risk appetite statement for the Group.

This places an overall limit on the total amount of risk that the Group is prepared to take. That position is set with respect to the returns that the Group is seeking to provide to shareholders, the credit rating that the Group is seeking to maintain, and the Group s capital position and desired capital ratios.

This position informs the Group s risk, capital and business management limits and policies. It is periodically reviewed by the Board as a part of the strategic planning process, or as the commercial circumstances of the Group change.

The Group manages risk within an established three lines of defence framework. The first line of defence comprises the business units managing the risks associated with their activities. The second line encompasses dedicated risk functions at both a Group and regional level, which are accountable for independent monitoring and oversight. The third line of defence relates to Internal Audit independently reviewing, monitoring, and testing business unit compliance with risk policies and procedures, and regularly assessing the overall effectiveness of the risk management framework. Control is exercised through clearly defined delegation of authority, with clear communication and escalation channels throughout the organisation.

The Group Risk Management Committee, chaired by the Group Chief Executive Officer, serves as the principal risk strategy and risk policy decision making management body within the Group, and provides the Board with assurance in the performance of the overall risk management framework. This committee is supported by five sub-committees Group Credit Risk Committee, Group Market Risk Committee, Group Operational Risk and Compliance Committee, Group Asset and Liability Committee, and Group Economic Capital Committee each with a specialised focus.

Each of the four major regions also has a regional Risk Management Committee comprised of senior regional executives, which serves to provide a leadership focus on key risk issues within the region.

*Refer to page 61 for Risk Committee members, responsibilities and charter.*

In response to the March 2004 APRA report on the foreign currency options trading losses, significant progress has been made to improve market risk systems, governance processes, and organisational culture although the organisation continues to invest in further development of systems and culture. Key outcomes include the reopening in May 2005 of the foreign currency options trading desk, and closure of all governance and culture related remedial actions in April 2006. The Group is also at an advanced stage with its internal market risk model re-accreditation.

**Risk factors**

The following are certain risk factors that may impact the Group s future results. The factors discussed below should not be considered to be the complete list of all potential risks.

*For a discussion of the Group s risk mitigation procedures, refer to risk mitigation on pages 16 to 20.*

**Credit risk**

As a financial institution, the Group is exposed to the risks arising from changes in credit quality and the ability of the borrowers or counterparties to fulfil their contractual obligations under loan agreements or other credit facilities. The Group s provision for doubtful debts provides for loan losses incurred in loans and advances. Estimating losses incurred in the loan portfolio is of its very nature uncertain and the accuracy of those estimates depends on many factors, including general economic conditions, rating changes, structural changes within industries that alter competitive positions, and other external factors such as legal and regulatory requirements.

**Market risk**

The Group s earnings are also subject to a range of market risks, principally changes in market interest and foreign exchange rates, equity and commodity prices, and associated financial derivatives.

**Liquidity and funding risk**

The Group is exposed to liquidity and funding risk and its banking entities must comply with the relevant regulatory liquidity requirements of the banking and other regulators in the countries they operate in.

**Operational risk**

As a financial services group, the Group is exposed to operational risks, being the risk of loss resulting from inadequate or failed processes, people or systems or from external events.

**Pension risk**

Pension risk is the risk that, at any point in time, there are insufficient funds available to meet the pension obligations due now and in the future. There are a number of factors that underpin pension risk, each with differing characteristics. Broadly, pensions risk can be described as being the aggregation of asset risk, liability risk and accounting risk. The Pension Group s principal exposure to pension risk is in the UK business.

**Regulatory risk**

The Group is subject to substantial regulation in the countries where it operates. The Group s businesses and earnings maybe affected by fiscal or other policies that are adopted by various regulatory authorities, or the failure to meet the requirements of those regulators.

Changes or developments in regulations, including accounting standards, could impact the earnings performance of the Group. The nature and impact of future changes in such policies are not predictable and are beyond the Group s control.

Regulatory agencies have broad administrative power over many aspects of the Group s business, including liquidity, capital adequacy and permitted investments, money laundering, privacy and record keeping. Financial services laws and regulations currently governing the Group, the Group s branches and subsidiaries may change in ways that could have an adverse impact on the Group s business. Also, bank regulators and other supervisory authorities in Australia, the United Kingdom, the US and elsewhere continue to examine payment processing and transactions under regulations governing such matters as money laundering, prohibited transactions with countries subject to sanctions and other anti-corruption matters. If the Group fails to respond appropriately to regulatory developments, actions or measures, the Group s reputation could be harmed and could be subject to additional legal risk, such as fines or penalties.

**Strategic risk**

Strategic risk is the current or prospective risk to earnings and capital arising from poor business decisions, improper implementation of decisions or lack of responsiveness to changes in the business environment. These include the quality of the strategic planning process, the achievability of the strategy, the implications of the strategy on risk appetite and the nature of products, services and customers targeted.

**Business conditions and general economy risk**

As an international financial services group, the Group s businesses are affected by conditions in the markets in which it operates. The profitability of the Group s businesses could be adversely affected by a worsening of general economic conditions in Australia, New Zealand, the UK, the US, or elsewhere, as well as by foreign and domestic trading market conditions.

**Legal risk**

The Group may be and is subject to legal proceedings, including tax disputes with the taxation authorities in Australia and New Zealand. The outcome of these proceedings could affect earnings.

*Refer to note 46 in the financial report for further information on the Group s contingent liabilities, including the tax disputes.*

**Fluctuations in currency exchange rates**

As the Group prepares its annual financial report in Australian dollars, changes in currency exchange rates, particularly between the Australian dollar and the British pound, NZ dollar or US dollar, may have an adverse effect on the earnings that it reports.

**Other**

Many other types of risks such as those pertaining to payment systems, computer systems fraud, legislative compliance, business continuity, disaster recovery and e-commerce risks exist and are managed throughout the Group.

**Risk mitigation**

For the major areas of risk, the processes for managing these risks is discussed below:

***Credit risk***

The Group s credit risk management infrastructure is designed to provide sound management principles and practices to maintain appropriate asset quality across the Group.

The Group has dedicated divisions within Group Risk Management, responsible for the development and maintenance of credit policies, large counterparties credit approvals, and the development and maintenance of key credit risk systems.

***Establishing an appropriate credit risk environment***

Significant credit risk strategies and policies are reviewed and approved annually by the Risk Committee of the Board, and ultimately the Board. Through such policies, the Board establishes the Group s tolerance for risk. These policies are delegated to management and administered under their guidance and control.

Single large exposure policies and industry concentration limits are in place across the Group. Overall composition and quality of credit portfolio exposures are monitored and periodically reported to the regional boards and the Board, and, where required, to the relevant supervisory authorities.

***Operating under a sound credit granting process***

The Group has established processes for the origination of credit. Key considerations include:

establishment of overall credit limits at the level of both individual counterparties and groups of connected counterparties for on- and off-balance sheet exposures;

satisfaction with repayment capacity and integrity of the counterparty;

use of fina