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Research Update:

Macquarie Group Outlook Revised To Positive, Macquarie Bank Outlook To Developing On Transitioning Of Risk Profile

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Macquarie Group Outlook Revised To Positive, Macquarie Bank Outlook To Developing On Transitioning Of Risk Profile

Overview

- MGL and MBL's risk profile is transitioning as reflected in the performance and risk management outcomes of the group and the bank as well as the reorientation of the group's businesses toward repeatable income sources.
- In our view, this transition is gradual and we are now at a point in time where there is at least a one-in-three probability that over the next two years we may reflect the positive transition in the group and the bank's credit profile. At the same time, the negative impact of a potential weakening of extraordinary government support is still weighing on the credit profile of the bank.
- We are revising our outlook on MGL to positive from stable reflecting the improving risk profile, and revising our outlook on MBL to developing from negative reflecting both the negative impact of a potential weakening of government support and the positive impact of an improvement in its risk profile. We are also affirming our 'BBB/A-2' ratings on MGL and our 'A/A-1' ratings on MBL.

Rating Action

On Dec. 11, 2018, S&P Global Ratings revised its outlook on Australia-based Macquarie Group Ltd. (MGL) to positive from stable and affirmed the 'BBB' long-term and 'A-2' short-term ratings on the group. At the same time, we revised the outlook on Macquarie Bank Ltd. (MBL) to developing from negative and affirmed the 'A' long-term and 'A-1' short-term ratings on the bank.

Rationale

MGL and MBL's risk profile is transitioning as reflected in the performance and risk management outcomes of the group and the bank as well as the reorientation of the group's businesses toward repeatable income sources, as opposed to capital markets facing businesses.

In our view, this transition is gradual and we are now at a point in time

where there is at least a one-in-three probability over the next two years that we may reflect the positive transition in the group and the bank's risk profile. In our assessment, we also reflect on the group and the bank's risk profile relative to international and local peers.

Our current risk profile assessment factors in that the group and the bank manage a wide and complex range of credit and noncredit risks across various businesses and geographies relative to traditional mainstream banks. It is our view that the nature of the group's activities are still more complex, especially in so far as legal and compliance risks are concerned, given the group's geographic and industry reach.

That said, we see signs of a gradual improvement in the group and the bank's risk profile over time, including:

- The group and the bank's performance and risk management outcomes pre and post the global financial crisis. Compared to a peer group of international banks, the volatility of the group's earnings has been lower for a sustained period.
- The reorientation of the group and the bank's earnings toward repeatable and sustainable income sources, which will benefit the group and bank's future earnings profile as well as risk management outcomes relative to international peer banks, which are more focused on capital markets.
- The activities of the group continues to be significantly more diversified in terms of geography and product relative to the Australian major banks, which are largely domestic-focused residential mortgage banks and which we assess at one notch stronger.
- The bank's trading activities continue to be largely client driven and proprietary trading positions are not out of kilter with international peers whose risk positions we assess a notch higher. We are also of the view that the bank has a lower risk appetite for proprietary trading positions relative to international peers.

The group is also currently undertaking an internal group restructure. The aim of the restructure is to simplify the group structure to better reflect the activities of the individual parts of the group's diverse businesses. It is our view that the completion of the internal restructure would improve the visibility of individual businesses as well as lessen the complexities associated with the group structure.

We also note that, to date, no material adverse findings have emerged from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, the final report of which is due Feb. 1, 2019. In our view, the group's risk management framework with regard to conduct appears to be sound relative to Australian major banks. We note that, in the past, the group has effectively dealt with enforceable undertakings and addressed recommended shortcomings in line with expectations.

In our view, the group's risk-management philosophy is sound, evidenced by an approach that focusses on the ownership of risk at the business unit level, understanding worst-case outcomes, and the requirement for the independent sign-off by risk management. We also note the bank's resourcing of its risk management group, with staff levels having nearly doubled over the last eight years. The group's risk appetite framework is well developed and sets out groupwide risk appetite principles that ensure that the group only accepts risks that comply with key criteria and within the group's risk limits and policies.

MGL Outlook

The positive outlook on MGL reflects our view that the rating on the group could benefit from an improvement in the group and the bank's risk profile.

Upside scenario

We see a one-in-three chance of an upside scenario over the next two years. A potential upgrade could occur if we formed the view that the group's risk profile has improved, including an improvement in the bank's risk profile. Triggers that we would consider could include 1) the finalization of the group internal restructure; 2) the ability of the group to deal with global credit headwinds; and 3) no signs that the group's risk appetite is increasing. In this scenario, and all other things remaining equal, we would expect to raise our issuer credit ratings on MGL and its senior debt by one notch to 'BBB+/A-2' from 'BBB/A-2'.

Downside scenario

We see limited downside risk to the rating over the next two years. Pressure on group credit quality could emerge in the low-probability event that leverage at the bank or the nonbank group significantly increased.

MBL Outlook

The developing outlook on MBL reflects both the downside scenario of the chance of a reduction in Australia's tendency to support systemically important banks and the upside scenario that MBL's risk profile could improve if it continues to deliver good risk management outcomes. The timeframe for these changes are not necessarily synchronized. For example, we could raise the ratings on the bank and revise the outlook to negative if we are of the view that the bank's risk profile has improved. Similarly, we could lower the

ratings on the bank and revise the outlook to positive if we concluded that overall government support for systemically important banks has weakened. Alternatively, we could affirm the ratings on MBL and revise the outlook to positive if we concluded that overall government support for systemically important banks remains unchanged. Lastly, if the two scenarios (government support and risk profile) played out in tandem, we could affirm the ratings on MBL and revise the outlook on the bank to stable.

Downside scenario

Our downside scenario reflects a one-in-three chance that we would lower our long-term issuer credit rating on MBL in the next two years if we revised the government's tendency to support private-sector commercial banks in Australia to supportive from highly supportive. We are likely to review our assessment of government supportiveness if government or regulatory announcements indicate a possible decrease in the government's appetite to support a failing bank or the development of a bank resolution framework that envisages statutory bail-in of senior debt, introduction of a total loss absorbing capacity framework. That said, we note that early in November 2018, the Australian Prudential Regulation Authority (APRA) released a discussion paper on the total loss absorbing capacity framework and we expect that the uncertainties that exists around the government's tendency to support systemically important banks will be resolved soon.

In this scenario, and all other things remaining equal, we would expect to lower our issuer credit ratings on MBL and its senior debt by one notch to 'A-/A-2' from 'A/A-1', and keep our ratings on hybrid and subordinated debt issued by MBL unchanged because these ratings do not incorporate any uplift from government support. As discussed above, we would revise the outlook to positive.

Upside scenario

Our upside scenario reflects a one-in-three chance of us revising upward our assessment of the bank's risk position to adequate from moderate in the next two years. Triggers that would consider could include: 1) the finalization of the group internal restructure; 2) the ability of the bank to deal with global credit headwinds; and 3) no signs that the bank's risk appetite is increasing. In this scenario, and all other things remaining equal, we would expect to raise our issuer credit ratings on MBL and its senior debt by one notch to 'A+/A-1' from 'A/A-1', as well as raise our ratings on hybrid and subordinated debt issued by MBL to reflect the improvement in our assessment of the bank's stand-alone credit quality. As discussed above, we would revise the outlook to negative.

Related Criteria

- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Financial Institutions - Banks: Bank Hybrid Capital And Nondeferrable Subordinated Debt Methodology And Assumptions, Jan. 29, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Financial Institutions - General: Key Credit Factors For Asset Managers, Dec. 9, 2014
- Criteria - Corporates - General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Financial Institutions - Banks: Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Criteria - Financial Institutions - Banks: Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - General: Update: Intermediate Equity Content For Certain Mandatory Convertible Preferred Stock Hybrids, Nov. 26, 2008
- Criteria - Financial Institutions - Banks: Commercial Paper I: Banks, March 23, 2004

Related Research

- APRA Proposal To Enhance Loss Absorbing Capacity Could Lead To Stable Outlook For Australian Major Banks, Macquarie Bank, Nov. 8, 2018
- Australian Major Banks, Macquarie Bank, Cuscal Still On Negative Outlook Despite Revision In Sovereign Outlook To Stable, Sept. 20, 2018

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Macquarie Group Ltd. Macquarie Financial Holdings Ltd. Issuer Credit Rating	BBB/Positive/A-2	BBB/Stable/A-2
Macquarie Bank Ltd. Issuer Credit Rating	A/Developing/A-1	A/Negative/A-1
Macquarie International Finance Ltd. Issuer Credit Rating	A-/Developing/A-2	A-/Negative/A-2

Ratings Affirmed

Macquarie Group Ltd. Senior Unsecured	BBB
Macquarie Bank Ltd. Senior Unsecured	A
Subordinated	BBB
Subordinated	BBB-
Junior Subordinated	BB
Preference Stock	BB+
Commercial Paper	A
Commercial Paper	A-1
Macquarie Bank Ltd. (London Branch) Senior Unsecured	A
Macquarie Securities South Africa Ltd. Senior Unsecured	BBB
Senior Unsecured	zaAAA
Short-Term Debt	A-2
Short-Term Debt	zaA-1+

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