FitchRatings

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Fitch Upgrades Macquarie Bank Limited to 'A+'; Outlook Stable

Fitch Ratings - Sydney - 26 May 2024: Fitch Ratings has upgraded Macquarie Bank Limited's (MBL) Long-Term Issuer Default Rating (IDR) to 'A+', from 'A'. The Outlook is Stable and reflects Fitch's view that MBL has sufficient headroom in its financial metrics to maintain its current rating, even in a scenario that is moderately weaker than our base case.

The upgrade of MBL's Long-Term IDR reflects the bank's build-up of qualifying junior debt instruments and equity to meet loss absorbing capacity (LAC) requirements, which, in conjunction with the Australian Prudential Regulation Authority implementing a formal resolution planning standard from the start of 2024, should protect third-party creditors in the event of a failure of the bank.

The Short-Term IDR of 'F1', Viability Rating (VR) of 'a' and Government Support Rating (GSR) of 'bbb' were affirmed at the same time. The ratings of MBL's subsidiaries and Macquarie Group Limited (MGL) were not considered as part of this review.

Key Rating Drivers

Stronger Junior Debt Buffers: MBL's Long-Term IDR is now above its VR, supported by the build-up of its junior debt buffers to address LAC requirements. The Australian framework requires LAC to be met through existing capital instruments. The bank has disclosed that the regulator will subject MBL to additional LAC requirements, consistent with the approach for the major banks. We believe the regulator sets MBL's LAC to be sufficient to reduce the risk of taxpayer funds being required to recapitalize the bank on resolution, thus protecting third-party senior creditors.

Tier 2 capital made up around 6.5% of MBL's risk-weighted assets (RWAs) at end-March 2024, with additional Tier 1 making up another 1.9%. MBL's VR is in line with the implied VR and is underpinned by the bank's sound business and financial profiles. The Stable Outlook reflects our view that MBL has sufficient headroom in its financial metrics to maintain its current VR, even in a scenario that is moderately weaker than our base case.

Internationally Diversified Operation: We take a blended approach when assigning the operating environment (OE) score to MBL, given the scope of its international operation. MBL's score reflects the heavy weighting of its assets and exposures to jurisdictions that we score in the 'aa' OE range. We also factor in MBL's higher exposure to Australian mortgages and high household leverage, resulting in a score at the lower end of the 'aa' category.

Market Share Growth: We expect MBL to continue to expand its Australian lending and deposit market share over the next few years. We believe MBL has the strongest market position among Australian banks outside of the four majors. Mortgage growth appears to have mainly been in the low-risk segment and not at the expense of weakening underwriting, which should support MBL's financial profile through the cycle.

Robust Risk-Control Framework: MBL benefits from MGL's centralised risk management framework, oversight through a dedicated risk group and strong risk-management culture, which has resulted in robust financial outcomes over a sustained period. This offsets the bank's larger risk appetite than at most other Australian banking groups.

Weaker Asset Quality: We expect higher interest rates and a modest rise in unemployment to weaken MBL's asset quality in 2024, with the stage 3 loans/gross loans ratio peaking at around 1.2%. MBL's asset quality score of 'a+' is below the implied 'aa' category score, as we apply a negative adjustment for historical and future metrics. Provisioning levels are likely to fall as impaired loan balances rise, but high levels of collateral coverage in the loan portfolio should limit losses.

Diversified Earnings Profile: The diversity of MBL's operation and revenue has supported sound profitability over an extended period and we expect this to continue. While operating profit dropped by 25% in the financial year ending March 2024 (FY24), it still marked the bank's second-strongest result to date. We expect stable earnings over FY25, with loan and customer growth offsetting margin compression, investment expenses and cost inflation.

Robust Capital Buffers: We expect MBL to maintain its operating common equity Tier 1 (CET1) ratio above 12.0%. The ratio stood at 13.6% at FYE24. While the bank may manage this down over the long-term through growth or other capital optimisation levers, we believe it will keep its capital buffers above regulatory minimums. Australia's regulator retain a level of conservatism in its application of the final Basel III rules, meaning the CET1 ratio appears modest relative to some international peers. We account for this by considering other metrics in addition to the CET1 ratio to assess MBL's capitalisation.

Sound Liquidity Management: We expect MBL's funding and liquidity to remain well managed, with the bank benefitting from its group's strong liquidity management. This offsets some risk from its greater reliance on wholesale funding than at international peers. MBL's deposit franchise continues to expand market share, consistent with its lending business. Its average liquidity coverage ratio was 191% in 1Q24, and its net stable funding ratio was 115%.

Rating Sensitivities

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/ Downgrade

LONG-TERM IDR

MBL's Long-Term IDR would be downgraded if the VR is downgraded. It may also be downgraded if the regulator no longer envisages MBL's junior debt buffers as sufficient to protect senior creditors in a resolution.

VR

The VR could be downgraded if a combination of the following were to occur:

- the four-year average of the stage 3 loans/gross loans ratio rising above 2.0% for a sustained period (FY19-FY23: 1.1%)

- the four-year average of operating profit/RWAs declining to below 1.5% for a sustained period (FY19-FY23: 2.8%)

- the CET1 ratio falling below 10% without a credible plan to raise it back above this level

- the business profile score being revised down to 'a-', possibly due to a large reduction in lending or MBL's deposit market position.

Deterioration or findings of significant deficiencies in MBL's risk-management framework and liquidity management could also pressure the ratings, as it would most likely result in a lower risk-profile score. This could negatively affect our assessment of some financial profile factors.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

Long-Term IDR and VR

An upgrade would require either the profile scores for MBL's business, risk, earnings and profitability or funding and liquidity, which are at 'a', to be revised to 'a+', assuming all other factor scores are unchanged.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

Short-Term IDR

The Short-Term IDR is at the lower of the two options available at a VR-driven Long-Term IDR of 'A+', because the 'a' funding and liquidity score is lower than the minimum 'aa-' score to achieve the higher option of 'F1+'.

Senior Unsecured

MBL's senior unsecured debt ratings are aligned with the IDRs, consistent with Fitch's Bank Rating Criteria.

Tier 2 Instruments

MBL's subordinated Tier 2 debt is rated two notches below its anchor rating - the VR - for loss severity, with non-performance risk adequately captured by the VR. The point of non-viability for these instruments is at the discretion of the regulator. None of the reasons for alternative notching from the anchor rating, as described in the criteria, are present.

MBL's GSR reflects its rising systemic importance over a number of years, underpinned by its position as Australia's fifth-largest bank by deposit and mortgage market shares of about 5%. We believe there is a high probability of support for MBL by the Australian authorities. We rate MBL's GSR higher than for its domestic non-major bank peers. MBL is also a significant participant in domestic financial markets, and is the only non-major bank that is subject to the Australian government's bank levy.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

Short-Term IDR

A downgrade of the Short-Term IDR would require the Long-Term IDR to be downgraded by at least two notches and the funding and liquidity score revised to below 'a'.

Senior Unsecured Instruments

The senior unsecured instrument ratings will be downgraded if MBL's IDRs are downgraded.

Tier 2 Instruments

The Tier 2 instrument ratings will be downgraded if MBL's VR is downgraded or if any of the reasons for higher notching outlined in Fitch's *Bank Rating Criteria* apply, although we view this as unlikely to occur.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

Short-Term IDR

The Short-Term IDR could be upgraded if the Long-Term IDR is upgraded by one notch to 'AA-' or the funding and liquidity score is revised to 'aa-' or above, assuming no change to the Long-Term IDR.

Senior Unsecured Instruments

The long-term senior unsecured instrument ratings will be upgraded if MBL's Long-Term IDR is upgraded. The short-term senior unsecured instrument ratings cannot be upgraded, as they are at the highest level on Fitch's rating scale

Tier 2 Instruments

The Tier 2 instrument ratings will be upgraded if MBLs VR is upgraded or if any of the reasons for lower notching outlined in Fitch's *Bank Rating Criteria* apply, although we view this as unlikely to occur.

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

A weakening in the propensity of authorities to provide support may result in Fitch lowering MBL's

GSR. However, this appears unlikely. A change in the ability of authorities to provide support is likely to be reflected in a downgrade of Australia's sovereign rating (AAA/Stable). However, this may not automatically result in a downgrade of the GSR if we believe the strength of the propensity to provide support offsets the lower ability to provide the support.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

An upgrade of MBL's GSR would require further significant increase in its systemic importance, which would most likely be reflected in its market share rising closer towards the level of the major banks. The GSR may also be upgraded if the Australian authorities provide additional, explicit statements of support for MBL, or otherwise provide greater certainty that support would be provided if needed.

VR ADJUSTMENTS

The asset quality score of 'a+' has been assigned below the 'aa' category implied score for following adjustment reason: historical and future metrics (negative).

Criteria Variation

Fitch applied a variation from its Bank Rating Criteria by upgrading MBL's Long-Term IDR to one notch above the VR. The criteria states that an uplift can be applied where a banking group's resolution plan envisages that the bank's third-party senior creditors will be protected on failure by a sufficient volume of qualifying junior debt and equity. We have applied the uplift without access to MBL's plan, as Australia's resolution and LAC framework envisages that senior creditors are protected on bank failure. We believe this effectively meets the intent of Fitch's criteria.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

The highest level ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3'means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/topics/esg/products#esg-relevance-scores

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Macquarie Bank Limited	LT IDR	A+	Upgrade		A
	ST IDR	F1	Affirmed		F1
	Viability	a	Affirmed		a
	Government Support	bbb	Affirmed		bbb
• senior unsecured	LT	A+	Upgrade		A

ENTITY/DEBT		RATING		RECOVERY	PRIOR
• subordinated	LT	BBB+	Affirmed		BBB+
• senior unsecured	ST	F1	Affirmed		F1

RATINGS KEY	OUTLOOK	WATCH
POSITIVE	⊕	⬘
NEGATIVE	⊖	⬙
EVOLVING	◉	◆
STABLE	⊙	

Applicable Criteria

Bank Rating Criteria (pub.15 Mar 2024) (including rating assumption sensitivity)

Additional Disclosures

Solicitation Status

Endorsement Status

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. For more details on sector-specific best- and worst-case scenario credit ratings, please see Best- and Worst-Case Measures under the Rating Performance page on Fitch’s website.

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