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CREDIT OPINION
16 February 2021

Update

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RATINGS

**Macquarie Financial Holdings Pty Limited**

| | |
|---|---|
| Domicile | Australia |
| Long Term Rating | A3 |
| Type | LT Issuer Rating - Fgn Curr |
| Outlook | Stable |

*Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.*


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# Macquarie Financial Holdings Pty Limited

## Update following rating action

## Summary


Macquarie Financial Holdings Pty Limited (MFHPL, A3 stable) is a subsidiary of Macquarie Group Limited (rated A3/P-2) and the intermediate holding company for part of the parent's non-banking operations, excluding the asset management operations. This includes the activities of some capital markets, securities trading businesses and corporate advisory. MFHPL's ratings reflect the consolidated entity's very strong profitability, high level of capital and very strong liquidity. These strengths are somewhat offset by the potential for higher earnings volatility and a higher risk asset profile.

MFHPL's ratings also benefit from its position as an intermediate holding company within the Macquarie Group and the highly integrated nature of its businesses and therefore we expect MFHPL would benefit from a very high likelihood of support. MFHPL's issuer rating also incorporates uplift for government support as a result of its close integration with MBL and the broader group.


## Credit strengths

» Strong profitability from solid franchise value.

» Diversified business profile with activities encompassing a number of business lines.

» Strong linkages to parent and other group entities.

## Credit challenges

» Complex and diverse nature of operations, requiring disciplined and proactive risk management.

» Markets facing business likely to be subject to more earnings volatility.

## Rating outlook

The outlook on MFHPL is stable, in line with the outlook for its parent Macquarie Group Limited and the group's banking operations, Macquarie Bank Limited.

## Factors that could lead to an upgrade

» MFHPL's ratings are strongly linked to those of Macquarie Group Limited. MFHPL could be upgraded if Macquarie Group Limited's ratings were upgrade.

## Factors that could lead to a downgrade

» Conversely MFHPL's ratings could be downgraded in Macquarie Group Limited's ratings were downgrade, or should the company increase its exposure to volatile financial markets, including any signs of loss of discipline in its risk management.

## Key indicators

Exhibit 1

**Macquarie Financial Holdings Pty Limited (Consolidated Financials) [1]**

| | 03-20[2] | 03-19[2] | 03-18[2] | 03-17[2] | 03-16[2] | CAGR/Avg.[3] |
|---|---|---|---|---|---|---|
| Net income (loss) (AUD Thousands) | 8,009,000.0 | 1,327,000.0 | 981,000.0 | 914,000.0 | 889,000.0 | 73.2[4] |
| Net income (loss) (USD Thousands) | 5,462,100.4 | 967,580.4 | 759,130.6 | 688,083.7 | 654,361.5 | 70.0[4] |
| Liquidity inflows / outflows (Securities) (%) | 8.5 | 17.2 | 26.0 | 36.0 | 34.8 | 24.5[5] |
| Long-term capital / Uses of long-term capital (Securities) (%) | 22.4 | 33.1 | 29.1 | 36.5 | 33.8 | 31.0[5] |
| ROAA (%) | 1.4 | 1.9 | 0.7 | 4.0 | 3.6 | 2.3[5] |
| (Total higher-risk assets and off-balance-sheet exposures) / Tangible Assets (Securities) (%) | 13.0 | 14.5 | 10.7 | 9.7 | 11.0 | 11.8[5] |
| (Tangible assets and off-balance-sheet exposures) / Tangible Common Equity (Securities) | 9.5x | 7.0x | 12.3x | 11.1x | 13.3x | 10.6x[5] |

[1] All of the quantitative credit metrics incorporate Moody's standard adjustments to financial statements in the analysis of financial institutions as per our cross-sector methodology; Moody's may also make other analytical adjustments that are specific to a particular securities firm. [2] IFRS [3] May include rounding differences because of the scale of reported amounts. [4] Compound annual growth rate (%) based on the periods for the latest accounting regime. Any interim period amounts presented are annualized for calculation purposes. [5] Simple average of periods for the latest accounting regime.

*Sources: Moody's Investors Service and company filings*

## Detailed credit considerations

### Strong intergroup linkages evident in funding profile

MFHPL strong integration with the broader Macquarie group is evident in the company's funding profile which relies heavily on intergroup arrangements to fund its operations. The group has also provided MHFPL with long-term funding through subordinated loans.

MFHPL's liquidity policies are in line with those of MBL and MGL, which are designed to ensure both entities meet funding requirements under a range of market conditions. The bank has a good stock of available liquid assets including cash and securities after haircuts. Liquidity outflows includes a large liability to body corporate entities (MGL).

### Very strong capital position with sizeable surplus capital

We consider MFHPL's capital adequacy to be very strong. Whilst not strictly regulated, as part of a broader licensed banking group, APRA has specified a regulatory capital framework for the Macquarie group, including its non-banking businesses. APRA has approved Macquarie's Economic Capital Adequacy Model (ECAM) for use in calculating the regulatory capital requirement of the Non-Bank Group, which is based on similar principles and models as the Basel III regulatory capital framework for banks, with both calculating capital at a one year 99.9% confidence level.

Under the ECAM, credit risk for the non-bank group is generally determined by using the Basel III Internal Ratings Based formula, but with internal estimates of key parameters. Capital requirements for equity exposures are an extension of the Basel III approach, On average the minimum capital required to be held against equity exposures is equivalent to 51% of the equity exposure face value.

The non-banking group, which includes MFHPL, Macquarie Group Limited and Macquarie Asset Management Holdings had a combined minimum capital requirement of AUD5.9bn against which, the non-bank group had eligible capital of AUD9.1bn as at 30 September 2020. Whilst the economic capital model covers a broader range of exposures and businesses than just MFHPL, the majority of the requirement is driven by Macquarie Capital (the primary business division operating within MFHPL), which generated AUD3.4bn of the AUD5.9bn minimum capital requirement, as at September 2020.

### Strong risk management but with a higher risk appetite

We consider MFHPL's risk appetite to be moderate with large interest in associates and joint ventures held on the company's balance sheet which we consider to be relatively illiquid and a low rated corporate lending portfolio. However, a key strength is Macquarie's strong risk management. This risk management is embedded across the group and the group's centralized risk function provides oversight across business lines.

MFHPL's corporate lending exposure is primarily to non-investment grade companies and includes a high percentage of loans classified as stage 3. Loans to non-investment grade borrowers represented c.74% of total loans. Similarly, a majority of MFHPL's trading and financial investments are categorized as level 3 assets (60%) which are likely to have weaker liquidity characteristics.

### Strong profitability supported by the group's very strong franchise, but capital markets businesses may exhibit higher earnings volatility

MFHPL's profitability is supported by the very strong franchise position of the Macquarie Capital business, with leading position in Australian capital markets and advisory businesses. These businesses have continued to generate strong fee and commission income for the group over a number of years, recording c.60% growth over the last 3 years. Furthermore the group's ability to generate gains from its principal investment activities (both realized and unrealized) has been the main driver for the significant profit growth since 2017. However, we expect the economic and societal impacts of the coronavirus pandemic could constrain the group's ability to complete transactions in its principal investment business over the next 12 months, which could constrain revenue and profits. In addition to this, credit impairment charges have risen given the deterioration in the economic environment and a period of elevated charges would be negative for profits.

With the earlier restructure and move of the asset management businesses out of MFHPL, we expect earnings volatility could be higher. As a business division, Macquarie Capital's pretax earnings volatility is high reflecting the potential uncertainty with regards to timing of income given the businesses market facing nature both in terms of its advisory work as well as its Principal Finance business in terms of developing and selling assets. This level of volatility is a constraint on the division's earnings profile.

### Non-bank group is funding intensive but stringent liquidity policy lowers the risk profile

Macquarie's non-bank business are funding intensive, with the funding channeled through MFHPL to related parties. Whilst this is a constraint on the credit profile, the group's stringent liquidity policy mitigates some of this risk.

Macquarie's liquidity risk management framework is robust and applies to both the bank and the non-banking group. Liquidity management is performed centrally by Group Treasury, with oversight from the Asset and Liability Committee and the Risk Management Group. Macquarie's liquidity policies are approved by the Board after endorsement by the ALCO and liquidity reporting is provided to the Board on a regular basis. The ALCO includes the MGL Chief Executive Officer, MBL Chief Executive Officer, Chief Financial Officer, Chief Risk Officer, Group Treasurer, Head of Balance Sheet Management and Operating Group Heads. The Risk Management Group provides independent oversight of liquidity risk management, including ownership of liquidity policies and key limits and approval of material liquidity scenario assumptions.

Liquidity policies are designed so that each of the bank group and the non-bank group maintains sufficient liquidity to meet its obligations as they fall due. The policy requires that the group is able to meet all of its liquidity obligations during a period of liquidity stress, defined as a 12-month period with constrained access to funding markets for the bank, no access to funding markets for the non-bank and with only a limited reduction in Macquarie's businesses. Reflecting the longer-term nature of the non-bank group asset profile, it is funded predominantly with a mixture of capital and long-term wholesale funding.

Macquarie applies the following risk tolerances with respect to its liquidity position:

» Term assets must be funded by term liabilities and short-term assets must exceed short-term wholesale liabilities.

» Cash and liquid assets must be sufficient to cover the expected outflow under a 12-month stress scenario and meet minimum regulatory requirements.

» Cash and liquid assets held to cover stress scenarios and regulatory minimums must be high quality unencumbered liquid assets and cash.

### Environmental, Social and Governance (ESG) considerations

In line with our general view for the financial services sector, MFHL has a low exposure to Environmental risks. See our Environmental risks heatmap for further information.

The most relevant social risks for banks and finance companies arise from the way they interact with their customers. Social risks are particularly high in the area of data security and customer privacy which is partly mitigated by sizeable technology investments and banks' long track record of handling sensitive client data. Fines and reputational damage due to product misselling or other types of misconduct is a further social risk. Societal trends are also relevant in a number of areas, such as shifting customer preferences towards digital banking services increasing information technology cost, aging population concerns in several countries impacting demand for financial services or socially driven policy agendas that may translate into regulation that affects banks' revenue base. Overall, we consider banks and finance companies to face moderate social risks.

Governance is highly relevant for MFHL, as it is to all players in the banking industry. Corporate governance weaknesses can lead to a deterioration in a bank's credit quality, while governance strengths can benefit its credit profile. Governance risks are largely internal rather than externally driven, and for MFHL we do not have any particular governance concern. Nonetheless, corporate governance remains a key credit consideration and requires ongoing monitoring.

### Operating environment

We assign Baa2 to MFHPL's operating environment based on the maturity of capital markets and the competitive dynamics of market markets in Australia. The operating environment score has no effect on MHFPL's financial profile score because it is at the same level as the financial profile score.

### Maturity of capital markets

We assign a score of A to the Maturity of Capital Markets sub factor of our scorecard for market makers participating in the Australian capital markets. The country's capital markets are characterised by a high degree of sophistication of market development, infrastructure, and regulatory oversight.

Australia has a deep equity market in relation to the size of its economy, supported by a wide range of investors, including retail, institutional and foreign investors. Notably, Australia has a large and growing superannuation (retirement savings) sector featuring mandatory employer contributions, within which asset allocation to equities is high. Market liquidity is good, with strong competition between global and domestic market makers. While Australia has an active retail market as well as a deep institutional market, equity market turnover is moderate when measured as a percentage of outstanding stocks. This may be a reflection of (i) the high proportion of superannuation fund assets with longer investment time horizons and (ii) the dominance of a relatively small number of stocks, due to concentrated industry structures in key sectors of the Australian economy. Equity index volatility has been low.

Australia's debt capital market is relatively less developed due to the high degree of bank intermediation and the proportionately lower allocation of pension fund assets to fixed income. Furthermore, within the fixed income segment, bank deposits constitute an important investment class.

Regulation of the financial sector is coordinated through the Council of Financial Regulators, which comprises the Reserve Bank of Australia; the Australian Prudential Regulation Authority (APRA); the Australian Securities and Investments Commission (ASIC); and the Australian Treasury.

Whilst oversight of capital markets by ASIC is focused on investor protection, key domestic market participants are subject to prudential supervision by APRA. In respect of regulated banks, APRA has a strong emphasis on supervision and a track record of mandating tighter capital and liquidity standards than required by the Basel Committee on Banking Supervision. In addition, the Council of Financial Regulators has overseen a programme of financial system architecture reforms that have resulted in advanced payments, settlement and clearing systems.

### Competitive dynamics

We assign a score of Ba to the Competitive Dynamic sub factor of our scorecard for market makers participating in the Australian capital markets. The competitive landscape in Australia is dominated by subsidiaries of global investment banks and a large domestic player, Macquarie Group. Competition amongst market makers for origination and customer flows in equities and in advisory services is intense, with a number of new foreign entrants and exits in the recent past. Debt capital markets are by comparison less developed, with a high degree of bank intermediation. This has allowed large domestic commercial banks to retain significant market share. Rising regulatory costs have provided some barriers to entry for incumbents, with smaller domestically-domiciled firms largely focusing on advisory services.

### Affiliate Support

MFHPL receives one notch of affiliate support from MBL. Even though MGL is the non-holding operating company, MBL dominates the group both in terms of assets and earnings. MGL's rating is positioned in line with Moody's usual notching practice for holding companies, which recognizes the structural subordination of MGL's creditors to those of its principal operating subsidiary.

We regard MFHPL's intrinsic credit profile to be closely aligned to the baa1 stand-alone rating of the bank, because the operations of the two are closely interlinked: three of the group's six business lines cross over the boundaries between MBL and MFHPL.

### Government Support

We judge the probability of systemic support for MFHPL in the event of stress to be high as a result of its close integration with the operations of MBL.

The probability of a high level of systemic support for MBL is due to its significant position in the Australian financial market. Additionally, the regulator's own Probability And Impact Rating System - which measures the systemic impact of the failure of an individual institution - uses asset size as a major input. As one of Australia's larger banks, MBL scores well by this metric. It also plays a significant role in Australia's financial markets. Although the bank does not have a big presence in the retail deposit market, it has been growing consistently and its overall deposits are comparable in size to Australia's regional banks.

## About Moody's Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

## Rating methodology and scorecard factors

Exhibit 2

**Macquarie Financial Holdings Pty Limited**

| Financial Profile | Factor Weights | Historic Ratio | Initial Score | Assigned Score | Key driver #1 |
|---|---|---|---|---|---|
| **Liquidity & Funding** | | | | | |
| Liquidity (Liquidity Inflows/Outlfows) | 20% | 8.5% | Ca | Baa1 | Offsetting assets & liabilities |
| Funding (Long-Term Capital/Uses of Long-Term Capital) | 15% | 22.4% | Ca | Ba1 | Related party funding |
| **Profitability** | | | | | |
| Return on Average Total Assets | 10% | 1.35% | A1 | A3 | Expected trend |
| Pre-Tax Earnings Volatility | 15% | NA | Ca | B2 | Expected trend |
| Risk Appetite & Leverage | | | | | |
| Risk Appetite ((Total Higher-Risk Assets + Off-Balance-Sheet Exposures) / Tangible Assets) | 20% | 13.0% | A1 | Baa3 | Heightened securities' risk |
| Leverage ((Tangible Assets + Off-Balance-Sheet Exposures) / Tangible Common Equity) | 20% | 9.6x | Baa2 | A2 | Expected trend |
| Financial Profile Score | 100% | | Ba3 | Baa2 | |
| **Operating Environment** | | | | | |
| Australia | Factor Weights | Sub-factor Score | Score | | |
| Macro Level Indicator | 0% | | Aa1 | | |
| Economic Strength | 25% | aa1 | | | |
| Institutions and Governance Strength | 50% | aa1 | | | |
| Susceptibility to Event Risk | 25% | a | | | |
| Maturity of Capital Markets | 50% | | A | | |
| Competitive Dynamics | 50% | | Ba | | |
| Home Country Operating Environment Score | | | Baa2 | | |
| | Factor Weights | | | Score | Comment |
| Operating Environment Score | 0% | | | Baa2 | |
| ADJUSTED FINANCIAL PROFILE | | | | Score | |
| Adjusted Financial Profile Score | | | | Baa2 | |
| Financial Profile Weight | 100% | | | | |
| Operating Environment Weight | 0% | | | | |
| Business Profile and Financial Policy | | | | Adjustment | Comment |
| Business Diversification | | | | 1 | |
| Opacity and Complexity | | | | -1 | |
| Corporate Behavior | | | | 0 | |
| Total Business Profile and Financial Policy Adjustments | | | | 0 | |
| | | | | | Comment |
| Sovereign or parent constraint | | | | Aaa | |
| | | | | | |
| Standalone Assessment Scorecard-indicated Range | | | | | |
| Assigned Standalone Assessment | | | | Baa2 | |

*Source: Moody's Investor's Service*

## Instrument class

Exhibit 3

**Macquarie Financial Holdings Pty Limited**

| Instrument Class | Assigned Standalone Assessment | Affiliate Support Notching | Government Support Notching | Individual Debt Class Notching | Assigned Rating |
|---|---|---|---|---|---|
| Issuer Rating | Baa2 | 1 | 1 | | A3 |
| Source: Moody's Financial Metrics | | | | | |

*Source: Moody's Financial Metrics*

## Ratings

Exhibit 4

| Category | Moody's Rating |
|---|---|
| **MACQUARIE FINANCIAL HOLDINGS PTY LIMITED** | |
| Outlook | Stable |
| Issuer Rating | A3 |
| ST Issuer Rating | P-2 |
| **PARENT: MACQUARIE GROUP LIMITED** | |
| Outlook | Stable |
| Issuer Rating | A3 |
| Senior Unsecured | A3 |
| ST Issuer Rating | P-2 |
| Other Short Term | (P)P-2 |

*Source: Moody's Investors Service*

REPORT NUMBER 1263456

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