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Credit FAQ:

Are Australian And New Zealand Structured Finance Ratings Immune To A Growing Economic Imbalance?

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Australian and New Zealand structured finance transactions face risks in 2017. The jump in private-sector debt and residential property prices in Australia during the past four years indicates rising economic risk for the nation's banks and finance companies (see "Rising Economic Risks Could Cut Ratings On Most Australian Financial Institutions By One Notch," Feb. 28, 2016).

Our ratings on Australian and New Zealand structured finance transactions are exposed to this risk at the level of loan portfolios and the transactions themselves, through their exposure to counterparties.

In this article, we examine what would happen to our ratings on structured finance transactions if we were to lower our ratings on Australian banks and finance companies. We also consider whether our ratings on Australian and New Zealand structured finance transactions are well-placed to weather a continued buildup of economic imbalances.

Frequently Asked Questions

How exposed are structured finance transactions to Australian financial institutions?

More than 90% of structured finance transactions in Australia and New Zealand are dependent on our ratings on the Australian financial institutions that were placed on negative outlook on Oct. 31, 2016 (see "Outlooks on 25 Australian Financial Institutions Revised To Negative On Rising Private Sector Debt And Property Prices," Oct. 31, 2016). The financial institutions are supporting counterparties. These counterparty exposures largely consist of the provision of bank accounts, liquidity support, derivatives, guarantees, or letters of credit to transactions.

About 85% of structured finance transactions in Australia and New Zealand are dependent on Australia's four major banks (see "How Will The Recent Outlook Changes On Australia And Australian Major Banks Affect Australian And New Zealand Structured Finance Ratings?", July 12, 2016). We consider the relationship of each structured finance instrument to that of the counterparty rating, in accordance with our "Counterparty Risk Framework Methodology And Assumptions" criteria, published on June 25, 2013. The major banks in Australia also act as counterparties to a number of New Zealand transactions.

What role do financial institutions play in structured finance transactions?

Australian financial institutions mainly play the role of interest-rate or currency swap provider, bank account provider, and liquidity provider in structured finance transactions.

How exposed are Australian and New Zealand structured finance ratings to counterparty risk?

We believe most tranches would not be affected if we were to lower by one notch our long-term ratings on the financial institutions that have a dependent role in structured finance transactions. This is because many of our ratings are supported by transaction structures that build up support over time, creating a buffer against the potential effect of

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any changes in counterparty ratings. Also, most transactions have some exposure to the Australian major banks. Under our Counterparty Risk Framework Methodology And Assumptions" criteria, counterparties with long-term ratings of 'A+' can support 'AAA' ratings for a range of roles. In addition, a number of structured finance transactions benefit from committed backup providers to meet minimum documented rating requirements.

Some short-term ratings would be affected if we were to lower to 'A-1' our short-term ratings on the Australian major banks. These instruments have direct links to the ratings on the banks and in the absence of alternate arrangements would be immediately affected (see "Standard & Poor's Analysis Of ABCP Ratings Following Changes To Ratings On Support Providers," published Dec. 18, 2008).

How do rising economic imbalances affect mortgage serviceability?

Borrowers are susceptible to any deterioration in economic conditions and rising interest rates when household debt and house prices are high. Debt serviceability is affected when an economy weakens to the point that people start losing their jobs. In such a situation, jobless borrowers unable to service their mortgages might be forced to sell their property at a loss. They might also face refinancing difficulties if lenders tighten their lending criteria.

Less-seasoned loans originated during periods of lower interest rates are more vulnerable to a decline in house prices and rising interest rates, but we do not expect the performance of most loans underlying Australian and New Zealand residential mortgage-backed securities (RMBS) transactions to deteriorate. A period of low interest rates has helped many borrowers to stay on top of their mortgage repayments and pay down their debt faster, building up more equity in their home loans. This is also supported by strong prepayment rates, which have averaged around 22% for the past five years.

How exposed are Australian and New Zealand structured finance ratings to rising economic imbalances?

Losses and defaults in structured finance transactions have remained low in Australia and New Zealand because both housing markets have remained relatively strong overall and economic fundamentals have been stable. Significant exposure to certain borrower types can create systemic problems, such as a housing market-led recession, however.

Arrears tend to be higher during softening economic conditions for nonconforming and low-documentation loans, which are typically extended to self-employed borrowers. Tougher economic conditions can precipitate a tightening in lending standards for such borrowers, restricting their access to refinancing opportunities. They then have greater difficulty managing their way out of financial difficulties. Low-documentation and nonconforming loans represent less than 2% of total Australian RMBS outstanding and around 5% of total New Zealand RMBS exposures, and do not have enough substance to create systemic problems.

High loan-to-value (LTV) ratio loans are also vulnerable to a softening in economic conditions; borrowers of such loans also are likely to face greater refinancing difficulties. Around 17% of loans outstanding in Australian RMBS transactions have an LTV ratio greater than 80%. Some of these exposures are in RMBS transactions in which the portfolio at close was made up entirely of high LTV loans. Only a few outstanding transactions now have these portfolio characteristics.

Less than 6% of total loans outstanding in New Zealand RMBS transactions have an LTV ratio greater than 80%.

How exposed are Australian and New Zealand RMBS transactions to a decline in property prices?

We consider property prices to be a second-order risk for Australian and New Zealand RMBS transactions. Strong appreciation in house prices has increased borrowers' equity; most Australian and New Zealand RMBS transactions have high seasoning of 60 months and 65 months, respectively. This is evidenced by the modest 60% weighted-average LTV ratios of Australian and New Zealand RMBS transactions. If the properties that secure the loans underlying RMBS transactions were revalued now, particularly those in Sydney, Melbourne, and Auckland, then this LTV level could be lower. This is because these cities have recorded strong appreciation in property prices during the past five years and many RMBS portfolios have reasonable geographic exposure to these cities.

In addition to modest LTV ratios, Australian and New Zealand RMBS transactions benefit from structural enhancements such as a strong build-up of credit support, particularly for senior notes. This enhancement continues to build for transactions paying sequentially. Excess credit enhancement provides an additional buffer to absorb losses and further insulation against a decline in property prices.

Related Criteria And Research

Related Criteria

- Methodology And Assumptions For Ratings Above The Sovereign--Single-Jurisdiction Structured Finance, May 29, 2015
- Methodology For Assessing Mortgage Insurance And Similar Guarantees And Supports In Structured And Public Sector Finance And Covered Bonds, Dec. 7, 2014
- Counterparty Risk Framework Methodology And Assumptions, June 25, 2013
- Standard & Poor's Analysis Of ABCP Ratings Following Changes To Ratings On Support Providers, Dec. 18, 2008

Related Research

- Rising Economic Imbalances And Weakening Government Support Pose Risks To Australian Banks' Credit Quality in 2017, Feb. 28, 2017
- How Do The Recent Outlook Revisions On Australian Financial Institutions Affect Australian and New Zealand Structured Finance Ratings? Nov. 6, 2016
- Outlooks On 25 Australian Financial Institutions Revised To Negative On Rising Private Sector Debt And Property Prices, Oct. 31, 2016
- Credit FAQ: How Will The Recent Outlook Changes On Australia And Australian Major Banks Affect Australian And New Zealand Structured Finance Ratings? July 12, 2016
- An Overview Of Australia's Housing Market And Residential Mortgage-Backed Securities, May 30, 2016

Only a rating committee may determine a rating action and this report does not constitute a rating action.