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Credit FAQ:

Explaining Standard & Poor's Rating Actions On Several New Zealand Financial Institutions Due To Rising House Prices

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Standard & Poor's Ratings Services today announced rating actions on a number of financial institutions in New Zealand, reflecting our view that the country's financial sector faces increased risks stemming largely from rising house prices in Auckland. In our opinion, accentuating these risks is the structural external weaknesses in the New Zealand economy (see media release titled, "Various Rating Actions Taken On New Zealand Financial Institutions Reflecting Rising Economic Imbalances," Aug. 14, 2015). Here, we further explain the rationale for these rating actions.

Frequently Asked Questions

Why are the financial institutions operating in New Zealand facing increased financial risks?

We believe the higher risk to New Zealand's financial system stems from increased imbalances in the economy arising from the strong growth in residential property prices, particularly in Auckland, over the past three years. Consequently, we believe the risk of a sharp correction in property prices has increased; and, if it were to occur, the impact on financial institutions would be amplified by the New Zealand economy's external weaknesses—its persistent current account deficits and high level of external debt. We have highlighted our view of increasing risks in the New Zealand financial system in several commentaries since 2013, during which period we placed the ratings on a number of New Zealand financial institutions on negative outlook (see Related Research).

We have taken into account macro-prudential tools implemented by the central bank that, in our opinion have been effective in controlling house price growth across New Zealand, excluding Auckland. While we consider that low interest rates have propelled credit growth and subsequently stoked house prices, we believe that housing supply constraints and high net immigration have also contributed to price appreciation. Nevertheless, we note that macro-prudential tools have only had a relatively temporary effect on house prices in Auckland, which resumed a rapid rise following a short period of abated growth. This is contrary to our previous base-case expectation that the macro-prudential tools would be more effective in stemming house price inflationary pressures across the country.

We have also taken note of other positive developments in the New Zealand banking sector in the past two years. The proportion of loans with high loan-to-value ratios (LVR) of more than 80% has reduced to about 15% of total bank mortgage lending at December 2014, from 21% in June 2013. In our opinion, these developments partly temper the increase in risks due to rising economic imbalances.

Does New Zealand have an asset price bubble that is about to burst?

No. In our base-case scenario, we expect that a sharp correction in property prices will not take place. In our view, the risk of a sharp fall remains low, although this risk has increased. Our base-case expectation remains that the heightened economic imbalances will unwind in an orderly manner. We note that the current house price appreciation in Auckland follows a period of restrained growth in private sector debt and national house prices for 2007 to 2011.

Should our base case of an orderly decrease in property prices not eventuate, how will a sharp correction in property prices affect the New Zealand financial institutions?

We believe that in a scenario of rapidly falling house prices, almost all New Zealand financial institutions would be exposed to a drop in operating earnings and a significant rise in credit losses. We note that a sharp decline in house prices in any country is generally accompanied by a weakening in other key macroeconomic factors, such as unemployment, household expenditures, corporate investments, and total economic activity.

In New Zealand's case, we expect that its external weaknesses would amplify the impact. We expect that the cost of external borrowings would rise, domestic credit conditions would tighten, the currency may depreciate sharply (damaging confidence and potentially limiting monetary policy flexibility), and economic growth would slow down, ultimately resulting in lower income levels. In such a scenario, we expect to see financial stresses on a countrywide basis, including the corporate, small-and-medium-size enterprises, and household sectors. We believe that this would significantly increase defaults by borrowers, and losses on such defaults, in addition to substantially lesser opportunities for profitable lending by financial institutions.

Why have you lowered your ratings on a number of smaller financial institutions (including banks and credit unions) that do not have significant home lending within Auckland, or a significant home-lending focus at all in some cases?

In our opinion, other things being equal, increased risks for the banking system in a country are generally likely to pressure all New Zealand banks and similar financial institutions--including mortgage lenders, credit unions, and building societies--that take deposits, extend credit, or engage in both activities. If a sharp fall in house prices in Auckland were to occur, we believe that most financial institutions in New Zealand would be adversely affected even when they do not have significant direct exposure to these properties. This is because of the importance of Auckland to the New Zealand economy, accounting for about 35% of the GDP and more than one-third of the country's population. Additionally, we believe that a plunge in house prices in Auckland would likely be accompanied by weakening in other macroeconomic factors, including GDP, employment, and business and consumer sentiment. In such a scenario, we expect that credit losses will likely increase for almost all the lenders in the country even when they have a limited exposure to both residential mortgage lending and Auckland.

Do you think that the financial sector in New Zealand has now become "risky" and that a number of financial institutions are facing imminent default?

Notwithstanding the increase in risks, we believe that New Zealand remains a relatively lower-risk banking system by global standards, as reflected in our revised score for the country's Banking Industry Country Risk Assessment (BICRA) of '4' on a scale of '1' (lowest risk) to '10' (highest risk). We consider that New Zealand's resilient economy, conservative banking regulation, and low risk-appetite support its banking sector. In our opinion, partly tempering these strengths are the country's moderately high private-sector debt; material dependence of the banking system on offshore and wholesale funding; and New Zealand's high external debt and current account deficit. Additionally, we have maintained high ratings by global standards for a predominant part of New Zealand's banking system, which is owned by the Australian major banks.

The ratings on the eight foreign-owned banks--including the four major New Zealand banks—remain unchanged. Does this mean that these financial institutions are unaffected by the increased economic risks?

No. To reflect the impact of increased economic risks in New Zealand's financial system, we have lowered the stand-alone credit profile (SACP) of almost all of the banks and similar financial institutions that we rate in New Zealand. In particular, the four major banks operating in New Zealand (including their parents' branches in New Zealand) account for close to 80% of system assets. Consequently, our view of the economic risks to New Zealand's banking sector substantially reflects our view of the risks faced by these institutions, and we have indeed lowered our SACP on these four banks.

However, our issuer credit ratings on the eight foreign-owned banks factor in our assessment of implicit or explicit support from their parents. We believe the likelihood of support for these New Zealand subsidiaries remains strong. Consequently, the ratings and outlooks on these entities remain equalized to those of their parents. We have applied the same rationale for lowering the SACP and affirming our issuer credit rating on UDC Finance Ltd. (AA-/Stable/A-1-+).

What is the stand-alone credit profile?

Standard & Poor's may assign a stand-alone credit profile (SACP) as a component of a rating to provide information on an issuer's creditworthiness. The SACP is Standard & Poor's opinion of an issuer's creditworthiness in the absence of extraordinary support or burden. It incorporates direct support already committed and the influence of ongoing interactions with the issuer's group and/or government. However, the SACP differs from the issuer credit rating in that it does not include potential future extraordinary support from a group or government during a period of credit stress for the issuer, except if that support is systemwide. The SACP also does not include the potential for the owner or government under stress to extract assets, capital, or liquidity from the issuer.

Do the increased economic risks affect your assessment of the SACP of the parent groups of the foreign-owned banks, including New Zealand's major banks?

A subsidiary's SACP indeed forms a part of our assessment of the credit profile of--and consequently the ratings on--the consolidated group. Nevertheless, the New Zealand operations of these foreign-owned institutions do not comprise, in our opinion, a large enough part of these groups to significantly affect the credit profiles or ratings on their parent groups.

Have any of these ratings or SACPs been lowered due to an increase in risks specific to an entity?

No. None of the lowering of the New Zealand financial institutions ratings or SACPs announced today were due to higher existing or emerging risks specific to the institution--such as any asset quality concerns. Rather, the lower SACPs or ratings on these institutions reflect our view that these entities were affected by the higher risk operating environment of the New Zealand banking system.

Why do the ratings and SACPs on the following remain unchanged— FE Investments Ltd., Kiwibank Ltd., Liberty Financial Ltd., Medical Securities Ltd., and Police and Families Credit Union?

The ratings on Kiwibank, Liberty Financial Ltd., and Medical Securities remain above their respective SACPs, reflecting our assessment of implicit or explicit support from their parents. Furthermore, we believe factors specific to these five entities have sufficiently neutralized the increased economic risks facing the New Zealand financial sector, maintaining their SACPs at the current level. The rating affirmations on FE investments and Police and Families Credit Union mirror their unchanged SACPs.

FE Investments Ltd. (B/Stable/B, SACP: b) and Liberty Financial Ltd. (BBB-/Stable/A-3, SACP: b-). Our SACPs on these entities remain unchanged because we believe that a variety of risk factors, including the current cyclical increase in the risk of a plunge in property prices is already factored to a degree in the modest SACPs of these entities.

Kiwibank Ltd. (A+/Negative/A-1. SACP: bbb). We believe that an improvement in Kiwibank's business profile has neutralized the impact of increased risks within New Zealand's financial system on Kiwibank's SACP. Consequently, although Kiwibank forms a predominant part of the of the group's earnings and assets, there is also no significant impact of the changes in bank-related credit-factors on our assessment of its parent's, New Zealand Post Ltd., overall credit profile. Nevertheless, the rating outlook on Kiwibank remains negative, mirroring that on New Zealand Post, which reflects pressures on the parent's postal business.

Police And Families Credit Union (BB+/Stable/B, SACP: bb+) and Medical Securities Ltd. (BBB+/Stable/---, SACP: bb+). Our SACPs on these entities remain unchanged because we believe that compared with their peers, these entities would be less susceptible to an increase in credit losses if there is a sharp correction in New Zealand's property market. This is because we consider that compared with their peers', the repayment capacity of their customer bases (largely the government-employed police officers for Police and Families, and doctors and other healthcare professionals for Medical Securities) exhibit relatively stable employment and income, and strong loan serviceability through economic cycles, including a fall in property prices.

Related Research

- Various Rating Actions Taken On New Zealand Financial Institutions Reflecting Rising Economic Imbalances, Aug. 14, 2015
- New Zealand Banking Sector Outlook: RBNZ On A Sticky Wicket To Remove "Speed Limits"?, March 17, 2015
- Macro-Prudential Policy For New Zealand's Financial System Represents A Good Start Toward Reducing Risks, June 4, 2013
- Outlooks On Eight New Zealand Banks Revised To Negative On Rising Economic Risks; Ratings On 15 Banks Affirmed, May 16, 2013
- New Zealand Banking Outlook: Significant Risk Remains Of A Sharp Correction In Property Prices, Feb. 27, 2013