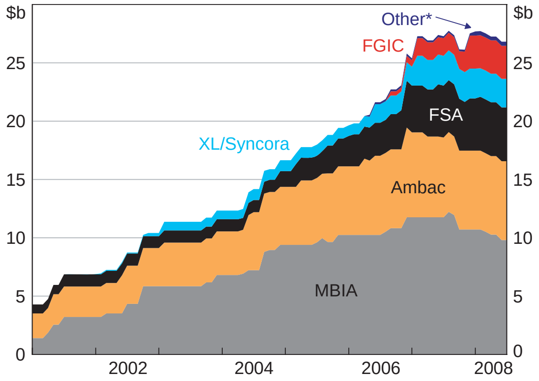
Box B: The Domestic Credit-wrapped Bond Market

Credit wrapping is a type of credit enhancement whereby a bond insurer guarantees to meet interest and principal payments if the issuer cannot. In Australia, credit wrapping is primarily used by lower-rated (generally BBB) investment-grade corporates – typically airports, utilities and infrastructure related issuers – to obtain a higher rating on their bonds. This is because the rating of a credit-wrapped bond is generally set at the higher of the insurer or issuer's rating. It also enables issuers to issue at longer maturities and lower spreads than otherwise. Very few structured credit products, such as asset-backed securities, are credit-wrapped in Australia, in contrast to the United States.

Graph B1

Australian Credit-wrapped Bond Market

Bonds outstanding by insurer



* Assured and Westpac

Source: RBA

There are currently around $27 billion credit-wrapped bonds outstanding in Australia, accounting for 7 per cent of the domestic non-government bond market (Graph B1). Almost all of these bonds are insured by US financial guaranty insurers, also known as monolines.[1] The two largest monolines operating in Australia are MBIA and Ambac, which have a market share of around 60 per cent.

Most of the monolines that are active in the Australian market have been downgraded this year, reflecting increased expected losses for US sub-prime RMBS and related securities, and the effect these losses – combined with the low expected business growth – would have on the monolines' capital (Table B1). These downgrades have flowed through to the insured bonds, with around 80 per cent of the domestic credit-wrapped bond market having been downgraded below AAA. Thus far, most of the bonds have been downgraded to the same rating as the insurer – typically AA.

Partly in anticipation of the monoline downgrades, the margin between credit-wrapped bonds and other non-government unsecured AAA-rated bonds in the secondary market has increased from an average of 25 basis points prior to the credit market turmoil to around 140 basis points (Graph B2). While the spreads on credit-wrapped bonds have increased, they remain significantly below spreads on bonds with similar ratings to the underlying issuers.

[1] *For more information on the monolines, see 'Box A: Financial Guaranty Insurers (Monolines)', RBA* Financial Stability Review, *March 2008, pp 16–17.*

Table B1: Monoline Ratings

	Market share	2007	Current		
	Per cent		S&P	Moody's	Fitch
MBIA	37	AAA	AA	A2	–
Ambac	25	AAA	AA	Aa3	–
FSA	17	AAA	AAA	Aaa	AAA
FGIC	11	AAA	BB	B1	CCC
XL/Syncora	9	AAA	BBB-	B2	CCC
Assured	1	AAA	AAA	Aaa	AAA

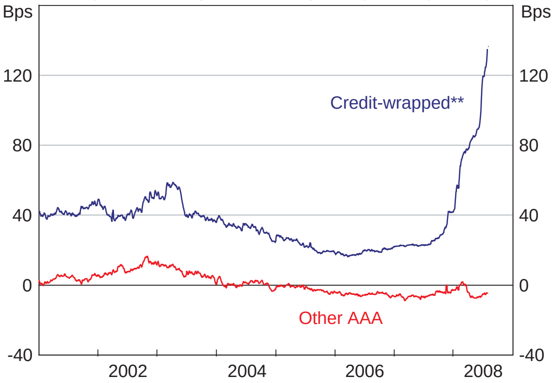
Sources: Fitch; Moody's; RBA; Standard & Poor's

Around half of credit-wrapped bond investors (banks, insurers, ABCP conduits and structured investment vehicles) have mandates to only hold highly rated bonds and may be required to sell, or have already sold, bonds that have been downgraded below AA. At the end of July, the value of credit-wrapped bonds downgraded below this by all of the major rating agencies was $5 billion. Most of the other investors are fund managers who can only hold investment-grade bonds. However, as the actual issuers of the bonds are generally rated at least investment grade, this would be likely to put a floor under the rating of these bonds, even if the monolines were to be downgraded below that. ✠

Graph B2

Domestic Non-government AAA Bond Spreads*

1–10 year bonds, spreads to swap, 5-day moving average



* Excludes asset-backed securities

** AAA at issuance

Sources: RBA; UBS AG, Australia Branch