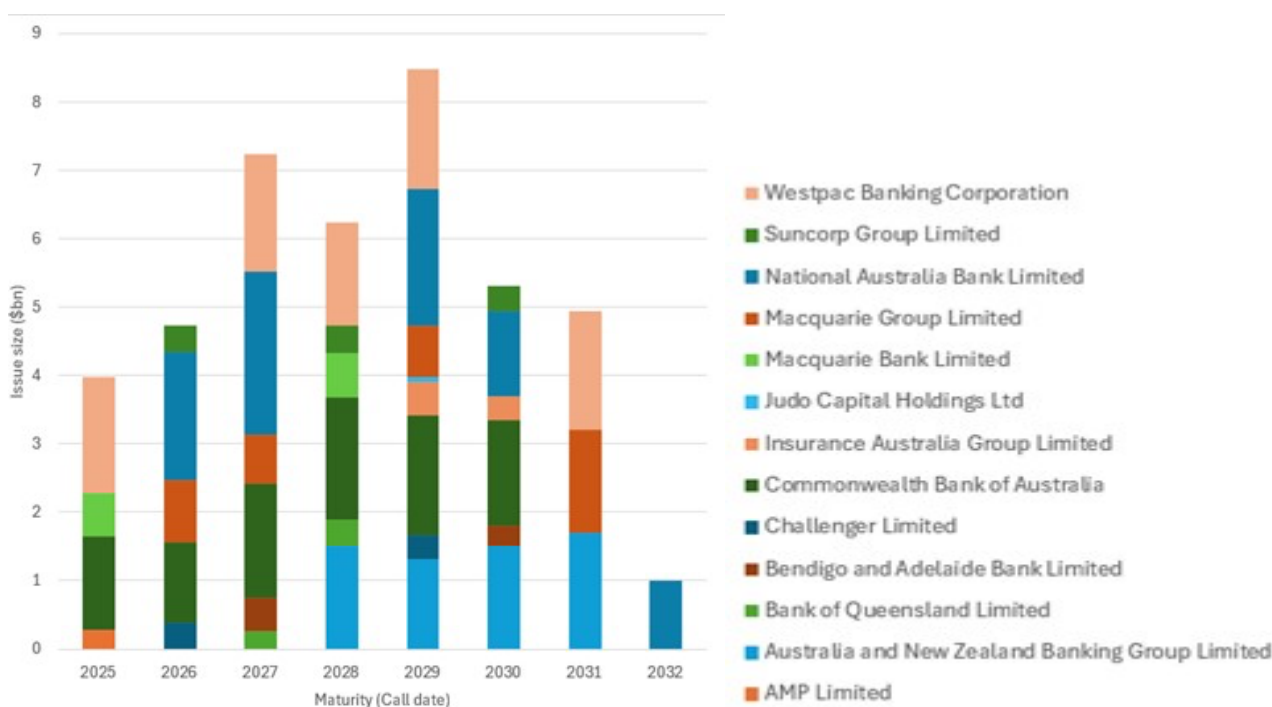


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Bank Hybrid Reinvestment

By James Verschoor

Four months since APRA announced the phase out of Additional Tier 1 (AT1) bank capital, investors are marking the beginning of the end of the beloved hybrid market. Last Thursday, ANZ redeemed their \$930m Capital Note 5, marking the first of the \$4.9bn in redemptions this year (see Graph 1). Not too far behind is CommBank's \$1.365bn PERLS 5 (CBAPH) on April 15, which has been confirmed to be redeemed at par. With these large sums of cash being handed back to investors, many are seeking alternatives to fill the impending gap amid a highly volatile market.



Source: Bloomberg

Since APRA's announcement of the phase out there has been a significant flattening of the AT1 curve as investors seek to lock in returns in longer dated securities. This has led to lower liquidity, seen through a widening in bid-offer spreads and declining turnover volumes.

Whilst investors typically look to hold AT1 until call, those who are interested in taking a more active approach may prefer to consider their options if they want to maintain a certain level of liquidity in their fixed-income investments.

Figure 3. Major Bank Tier 2 vs AT1 5-year trading margin



Source: BondAdviser

Major bank tier-2 (T2) subordinated bonds offer a potential solution to AT1 investors who are interested in quality risk-adjusted returns and liquidity. Tier 2 currently provides reasonable risk-adjusted returns, especially as AT1 spreads begin to converge (see Graph 2), offering running yields of 6% - 6.5%. This is reasonable when considering the investor is moving up the capital stack under the same issuer. From a liquidity perspective, the Australian bank T2 market stands out at roughly 1.5x the size of the outstanding volume of the current bank AT1 market. This is important to consider as the AT1 market declines 10% per annum and the buyer pool shrinks, potentially leading to opportunity costs as new issues come to market.

For those interested, below is a list of available bank tier-2 investment options to switch out of recent and incoming AT1 redemptions.

Issuer	Sector	Coupon Type	Coupon Formula	ISIN	Call Date	Yield
COMMONWEALTH BANK AUST	Financial	FIXED	6.704%	AU3CB0297653	15-Mar-33	5.650%
WESTPAC BANKING CORP	Financial	FIXED	7.199%	AU3CB0304376	15-Nov-33	5.660%
NATIONAL AUSTRALIA BANK	Financial	FIXED	6.342%	AU3CB0310175	06-Jun-34	5.709%

Major bank Tier-2

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