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T2 Credit Spreads: There's More Room to Tighten

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Tier 2 credit spreads have tightened significantly in recent months, capturing the attention of fixed income investors across Australia. Despite spreads hovering at historically low levels, a combination of supportive market dynamics and regulatory shifts suggests there may be further room for tightening.

Current Spread Analysis

Recent market data reveals that T2 spreads continue to compress, with major Australian bank T2 securities now quoted around 130–145 bps over swap for 5-year maturities. In comparison, senior bank paper trades much tighter, typically in the 60–70 bps range, while AAA-rated RMBS (Residential Mortgage-Backed Securities) are even tighter, often under 50 bps. The T2-to-senior spread multiple remains elevated, suggesting that T2 still offers a meaningful pick-up over senior debt, even though absolute levels are tight.

Looking back over the past decade, current T2 spreads are near the lower end of their range but not at all-time tights. Previous cycles have shown that in periods of strong capital positions and low default risk, T2 can trade as tight as 110–120 bps. Notably, earlier predictions of a bottom in T2 spreads have been repeatedly challenged as technical and demand factors have driven further compression. This historical context suggests that, while valuations are rich, there is precedent for further tightening.

T2 Yield Comparison

With the RBA maintaining a cautious stance, term deposit rates have plateaued around 4% per annum, while high-yield savings accounts offer little more. ASX200 dividend yields sit near 4–4.5%, with franking credits providing an additional boost, but with greater volatility and less capital stability. ASX-listed hybrid securities yield 5–6% but carry distinct equity-like risks. By contrast, major bank T2 securities currently yield 5.4–5.7% (gross), offering an attractive risk-return profile for income-oriented investors seeking a balance between yield and credit quality.

Capital and Regulatory Update

Australian banks remain exceptionally well-capitalised, with Common Equity Tier 1 (CET1) ratios comfortably above APRA's "unquestionably strong" benchmarks. The ongoing wind-down of

Additional Tier 1 (AT1) issuance, following recent APRA guidance, is set to reduce overall supply of subordinated paper. Regulatory changes, including the move to higher risk weights for mortgages and the implementation of Total Loss Absorbing Capacity (TLAC) requirements, have shifted issuance patterns but ultimately reinforce the strength of bank capital positions. The net effect is a moderation in new T2 supply, providing a tailwind for existing securities.

Technical Factors: Demand and Market Dynamics

Several technical factors underpin the tightening bias in T2 spreads. First, multiple Australian banks have received ratings upgrades or outlook improvements, reducing perceived credit risk. Second, with limited new issuance and a steady roll-off of existing securities, investor demand has outstripped supply. This imbalance has been further amplified by global investors seeking exposure to high-quality Australian bank credit, attracted by both the yield premium and the robust regulatory environment. These dynamics create a powerful technical bid supporting further spread compression.

Our Outlook

Although T2 credit spreads are tight, the confluence of strong bank capital, supportive regulatory settings, and favourable technicals suggests that further tightening is possible. Investors may consider adding exposure to major bank T2 securities, particularly on any market weakness or primary issuance that offers a new issue premium. Key risks include a sudden deterioration in global credit sentiment, unexpected regulatory changes, or a material increase in bank funding needs. Nonetheless, the balance of factors favours a constructive outlook for T2, with potential for spreads to move closer to historical tights.

Final Thoughts

Tier 2 credit spreads remain tight but could tighten further, driven by strong capital positions, limited supply, and robust investor demand. Compared to other income-generating assets, T2 offers a compelling yield with high credit quality. While risks remain, the current environment supports a positive trade idea for investors seeking incremental yield in a stable credit market. As always, careful security selection and active monitoring are essential to manage risks and capture opportunities in this evolving landscape.

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