

Final call for Australian bank hybrids. What's next for hybrid investors?

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Commonwealth
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Final Call for Australian bank hybrids/ What's next for hybrid investors

At a time when fixed income investors are benefiting from cyclically high yields, bank hybrid investors now face a marked reduction in their investment opportunity set. We speak, of course, of Australian Prudential Regulation Authority's (APRA) decision late last year, which was reconfirmed by APRA on 8 July 2025, to phase out hybrid capital for Australian banks. This means that additional Tier 1 (or AT1) regulatory bank capital and the ASX-listed bank hybrid market will progressively disappear by 2032. Hybrid investors will be required to seek alternative investment options that meet their risk/return profile, which we highlight below. But first, a few key points on APRA's decision, to provide context on this new fixed income investment landscape.

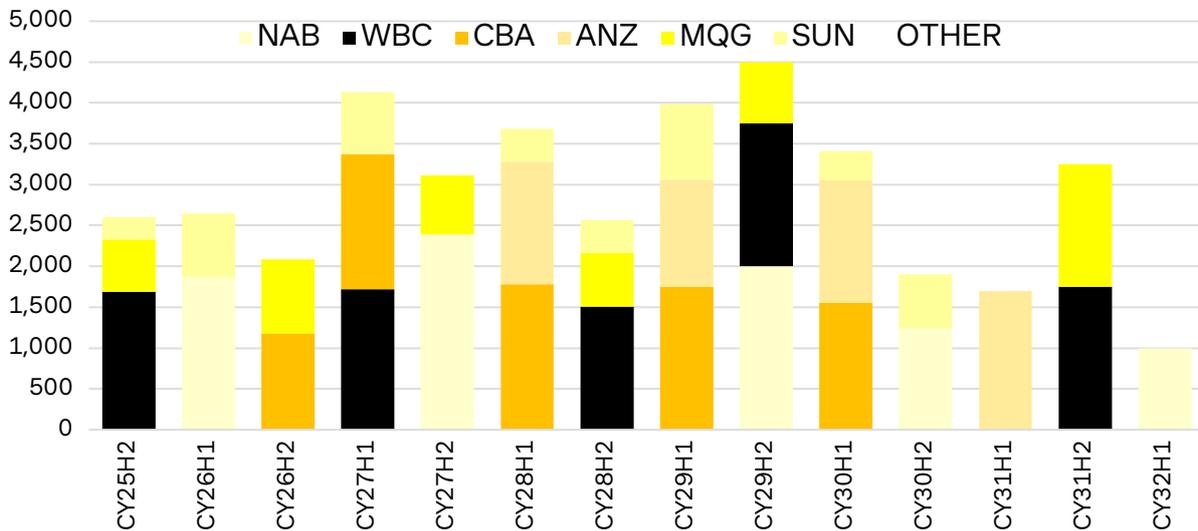
Under APRA's changes, larger domestic banks will be required to replace AT1 capital, primarily with Tier 2 (or subordinated) debt, as well as a modest amount of core equity (CET1) capital. Smaller banks will need to replace all AT1 instruments with Tier 2 capital. This includes those banks that operate and issue AT1 capital under a bank non-operating holding company (e.g. Macquarie Group). With most domestic banks having chosen the ASX-listed market as their access point (and in doing so, tapping Australian retail investors – a core concern for APRA), the current size of the ASX-listed hybrid market is ~\$40 billion. While insurers are unaffected by these changes, in practice, issuance sizes from the likes of IAG and Suncorp have been much lower compared to that for the major banks and don't form a material part of the hybrid market. On 8 July 2025, APRA released an updated paper, in which

the regulator ostensibly reconfirmed the key decisions and timelines that was outlined in their edict to domestic banks in December 2024.

Since APRA's announcement last year, the issuance of listed bank hybrids has ground to a halt. While refinancings via new bank hybrids are technically possible in the shorter-term under certain conditions, we believe most bank issuers will not contemplate re-issuing ASX-listed AT1s. Meanwhile, with existing ASX-listed hybrids attracting a scarcity bid, their trading margin (TM) and liquidity levels have declined to near record lows. Evidencing this, from a high of approximately ~370 basis points in 2022, the TM for a major bank AT1 with a circa five-year call date has declined to the low 200 bps area over BBSW as of early-July 2025.

In practice, with banks now further incentivised by APRA to redeem their outstanding hybrids at the first call date, at or before redemption, hybrid investors may seek to re-deploy this capital into alternative income-based investments at similar yields. We address this topic below. We note that in 2025, 2026 and 2027, circa \$15 billion of ASX-listed financial AT1s are due for call (please refer to the below chart), so the reinvestment task is significant for ASX-listed hybrid investors.

Schedule of call dates for ASX-listed financial AT1s



Source: Commonwealth Bank of Australia

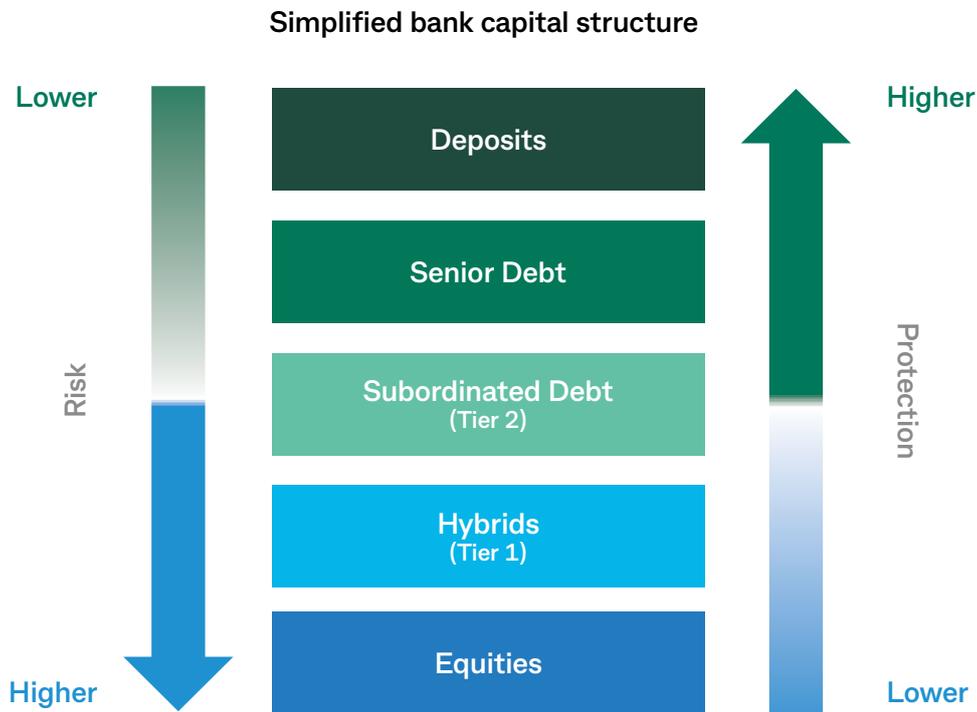
Tier 2/subordinated debt

APRA's requirement back in 2019 for Australian banks to hold higher levels of total loss absorbing capital (TLAC) has led to significant growth in AUD Tier 2 issuance and the size of the subordinated debt market generally. The advent of foreign banks seeking funding diversification down under has also been a key driver. The regulator's latest move on AT1 capital only adds further impetus to this dynamic – given that ASX-listed bank hybrids will mainly be replaced with Tier 2 capital, this implies an approximate 30% increase to the Australian bank Tier 2 universe over the next seven years (Source: BondAdviser). With the expansion in outstanding Tier 2 issuance in recent years, and with major bank Tier 2s now rated A- or equivalent with all three rating agencies, so to, has the investor base and liquidity in this market.

With the decline in TM and yields to call for listed AT1s, major bank hybrid investors can now access similar yields for AUD Tier 2s issued by the major banks, but in doing so, move higher up the capital structure (as noted in the below chart). While AT1 investors will experience

a decline in income reflecting the lower coupon margins that Tier 2s offer as less risky instruments than hybrids, subordinated debt still carries risks which clients need to observe when making their investment decisions. These risks include the higher credit spread sensitivity of financial Tier 2 bonds compared to their senior counterparts, and call (or extension) risk – this the risk that the financial issuer doesn't redeem and repay its Tier 2 bond at the issuer's early call date. From an execution standpoint, given that Tier 2 bonds are typically purchased by institutional investors in the wholesale market, investors will need to be mindful of the minimum parcel sizes for each bond, which is currently \$500,000 under Austraclear settlement. For these reasons, some investors may consider a Tier 2-based ETF or the below fixed income funds as more suitable vehicles through which to invest.

Overall, however, Commonwealth Private views the opportunity and return potential in Tier 2s, notably those investment-grade bonds issued by the well-capitalised domestic major banks, as sound on a risk-adjusted basis.



Source: VanEck

Actively managed fixed income portfolios

As readers of our [Market Outlook](#) will appreciate, Commonwealth Private remains an advocate for diversified fixed income managers/funds that actively manage their interest rate and credit exposures, especially in this environment of higher market volatility. These strategies have key defence tools to mitigate the portfolio impact of any future interest rate and/or credit market weakness.

In this regard, to complement our existing core fixed income model, Commonwealth Private plans to make available to clients, a Yield Model with a return target over AUD cash rates that is either on par with, or higher than, the current yields to call for ASX-listed major bank hybrids. Specifically, this largely investment-grade funds of fund portfolio will seek to deliver, over the medium-term, a return target (net of fund management fees) of RBA Cash +2.7% at least, while maintaining a focus on capital stability. Depending on their risk and return parameters, existing listed hybrid investors may find this upcoming Yield Model of interest.

Other alternatives

Other notable options that are available include corporate hybrids, listed investment trusts (LITs) and listed notes. Seeking to fill the vacuum from the receding ASX-listed hybrid market, these latter two structures provide a similar return profile to that of major bank AT1s by investing in a portfolio of (largely) private credit assets.

Noting that the above alternatives are all yield-based options, Commonwealth Private also offers diversified model portfolios that provide income streams to clients.

Above all, when deciding where to re-deploy their hybrid capital, it is important for clients to remain discerning and select the hybrid replacement option that is most suitable for their risk and return parameters.



For more information

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