

Why our head of fixed income is taking profits on Aussie subordinated bank debt

By Perpetual Asset Management

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Fixed income is about understanding the relative risk-reward scenarios among asset types – and knowing when to sell, says Perpetual's Vivek Prabhu.

- Understanding capital structures is critical
- Limited upside left in Aussie bank sub debt
- Find out about [Perpetual Diversified Income Fund](#)

For the past two years, Perpetual's head of fixed income Vivek Prabhu has been overweight Aussie bank subordinated debt – but now he's taking profits.

In this article he explains why.

[In early February, Prabhu explained why he saw good value in subordinated debt](#) – a type of tradeable, unsecured bank debt that sits between hybrids and senior debt in terms of risk.

Subordinated debt is generally considered less risky than hybrids (a type of bank debt that converts into equity in times of trouble), but riskier than senior debt (which has a higher priority for repayment in the event of trouble).

Why is now the time to take profits on subordinated debt holdings?

Prabhu – who manages [Perpetual Diversified Income Fund](#) – points to a shrinking of credit spreads between subordinated bank debt credit and senior debt.

Aussie bank hybrid credit premiums are narrowing relative to Aussie bank subordinated debt

Over the past two years, subordinated debt has been screening as cheap, while hybrids have been looking expensive.

“But sometimes things are cheap for a reason, and you don't want to own them,” points out Prabhu. “So it's important to dig a little further on the credit fundamentals.”

Before buying subordinated debt, Prabhu overlayed the fact that banks were required to hold more capital after the global financial crisis.

“As bond holders, that meant there was twice as much capital protecting us.”

Adding to his confidence, new rules required banks to increase what's known as Tier 2 capital, which includes subordinated debt.

“Subordinated debt was cheap because of the sheer volume of supply (ie bond issuance) required from banks to comply with the new requirements for Tier 2 capital,” Prabhu says.

In addition, Prabhu anticipated potential upside from a possible upgrade to the credit quality of Aussie bank subordinated debt.

He spoke about this [in an article back in early February](#) – which turned out to be correct.

“In March, Moody’s upgraded major bank subordinated debt one notch from Baa1 to A3.

“Then in April Standard & Poor’s did the same thing, raising its rating one notch from BBB+ to A-.

“The credit premiums on this debt contracted (reflecting lower risk premiums following the improvement in credit quality) with the subordinated bonds rising in value as credit risk premiums fell.

“An additional benefit was that subordinated debt became more liquid as a wider array of investors were attracted to invest in these higher-rated bonds.

“For example, regulated entities – such as insurers who hold a large portion of their reserves in fixed income – were more attracted to subordinated debt as the regulatory capital charges applied to owning these bonds become less punitive following the upgrade to their credit ratings.”

Shrinking credit spreads between subordinated debt and senior debt

The ratio of credit yield premiums on bank hybrids relative to bank subordinated debt is just one measure of value, Prabhu explains.

“Another measure is to compare subordinated debt to senior debt.”

In 2020, the Reserve Bank introduced low-cost, three-year funding – the Term Funding Facility (TFF) – which was offered to authorised, deposit-taking institutions.

The intention was to ease the impact of the pandemic.

But the credit premium on senior bank bonds was tainted by this market intervention, says Prabhu.

“It overshot on the downside and went as low as 28 basis points.

“The TFF expired in June 2023 – and as the TFF funds were repaid by the banks to the RBA, they returned to debt markets to get their funding.

“The debt market now once again provides a market clearing price (for credit spreads) untainted by the TFF.”

The ratio of subordinated bank debt credit premiums relative to senior debt suggests the former is now around fair value, Prabhu says.

“With credit premiums on senior bank debt towards the bottom of their (untainted) range over the last decade, further upside from any fall in credit risk premiums is limited.”

“Credit spreads have come down a long way.

“For me, there isn’t a lot of upside left in Aussie major bank subordinated debt, so that’s why I’ve been reducing my exposure in recent months (July-August) and taking profits.”

Find out about [Perpetual Diversified Income Fund](#)

About Vivek Prabhu and Perpetual's Credit and Fixed Income team

Vivek is Perpetual's head of fixed income. He joined Perpetual in 2004 and has more than 30 years of experience in accounting, finance, investments, governance and risk management. He has managed multi-billion-dollar fixed income, credit and currency portfolios and his role involves credit analysis, trade execution and portfolio construction.

Perpetual offers a range of cash, credit and fixed-income solutions and are specialists in investing in quality debt.

We take a highly active approach to buying and selling credit and fixed income securities and invest extensively across industries, maturities and the capital structure.

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VICKI HARRIS

Head of Credit & Fixed Income

BBus, FCA, Grad Dip App Fin & Inv, MBA, GAICD

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