RATES

03 February 2022

Bond versus Bank finance: An analysis of rates

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In the current scenario, where interest rates are rising (20bps increase in 10Y Gsec yield in Feb'22, 15bps increase in AAA rated corporate yield and 18bps increase in AA+ paper of 10Y tenor), the primary challenge is funding. Corporates with rating of AA and above have tended to get better rates in the bond market. An exercise is conducted where we compare 1Year MCLR of banks with yield for corporates of different ratings. This is done to see at what which rates bond/bank financing is a viable option.

Funding a constraint: The demand for credit is going to grow at a steady rate as India embarks on the journey to achieve the $ 5 trillion mark of nominal GDP. This will require substantial investment especially in infrastructure and manufacturing. The main challenge is funding. For long term investment ideally, we need to have a strong bond market. However, today there is a lot of reliance on banks for long term capital even with the coexistence of bond market that have been growing quite smartly. The catch is really that the corporate bond market is a restricted one for companies. It tends to be the higher rated companies which can access this segment. It is not surprising that the rest of the companies come back to banks for borrowing.

There have been sturdy arguments that we need to have strong credit enhancements in the system where the lower rated companies can get upgraded. But this is still work in progress. The banks evidently have a major role to play still even though there would be a new DFI in operation soon as the institution has already been established.

An analysis of cost of borrowing: Cost of borrowing is an important factor which determines where companies borrow from. While the rating is the deciding factor, it is instructive to analyse as to how the cost varies in the corporate bond market for different rated paper. This can be juxtaposed with the MCLR of banks. The limitation is that the MCLR is available for one year while the typical bond issuance is for tenures that are more than 5 years. Notwithstanding this limitation, it would be still possible to draw certain conclusions.

Concluding remarks: Corporates with rating of AA and above have tended to get better rates in the bond market. In the current financial year this benefit has gone down to lower rated paper too due to the general tendency of Gsec yields to be low. There is however, no uniformity when comparing over different tenures as for 3 year tenure bond markets were good for even A+ rated companies to begin with but with yields going up since Nov'21, have made bank borrowing of higher advantage. Going forward, the GSec movements and repo rate changes will hold the clue to interest rate differential in the two segments.

Approach

An exercise is conducted comparing different rates for corporates with different ratings with 1Year MCLR of banks.

The purpose is to see at what rates corporates with different ratings have borrowed from the bond market and at which level of rating bank channel seems the better option.

Here we have constructed tables for different tenor papers – 1 and 10 years for the current financial year (monthly averages) and for the last 6 years (annual averages), to examine if there have been any changes in these trends.

Computation is done using Bloomberg FIMMDA yield curve of different maturities and taking daily average of the same to arrive at monthly or financial year values. Here too, it must be pointed out that when FIMMDA provides these rates it is based on algorithms as there could be no trading in several securities especially in the lower rated securities such as BBB and lower and even A at times.

We distinguish between the MCLR of PSBs and PVBs to make the conclusions a bit sharper.

Observations:

The shaded areas are the rating categories which have interest rates in the bond market lower than the corresponding 1 Year MCLR of PSBs (median rate). *Thus, we may arrive at a judgement that at those rates corporates are more likely to borrow from the market.* This is given in Table 1 and Table 2 for 1 year and 10 years paper for the period April 2021 to January 2022. The 1 year paper though not very popular is included here mainly because the tenure matches the MCLR one.

- For 1 Year paper, corporates with rating A- may have to resort to bank finance considering the interest rate differential of borrowing.

- For 10 Year paper, AA, AA-, A+, A and A- corporates may consider the option of borrowing through banks. The bond market is hospitable for AAA and AA+ rated paper of companies.

Table 1: A- Rated corporates might go for lending through bank channels for 1 Year basis

1 Year										
FY22	GSec	AAA	AA+	AA	AA-	A+	A	A-	MCLR*, PSBs	MCLR*, PVBs
Apr	3.83	4.16	4.64	5.10	5.60	6.05	6.83	7.60	7.33	8.40
May	3.79	4.19	4.67	5.12	5.71	6.16	6.93	7.71	7.33	8.45
Jun	3.87	4.21	4.62	5.05	5.76	6.21	6.98	7.76	7.30	8.30
Jul	3.88	4.08	4.55	5.00	5.72	6.17	6.95	7.72	7.30	8.25
Aug	3.83	4.07	4.54	4.92	5.58	6.03	6.81	7.58	7.30	8.23
Sep	3.93	4.13	4.58	4.95	5.65	6.10	6.87	7.65	7.30	8.23
Oct	4.16	4.44	4.84	5.21	5.90	6.35	7.13	7.90	7.25	8.15
Nov	4.24	4.60	5.02	5.31	5.98	6.43	7.21	7.98	7.25	8.15
Dec	4.37	4.71	5.06	5.31	6.23	6.68	7.46	8.23	7.25	8.20
Jan	4.38	4.80	5.16	5.45	6.34	6.79	7.56	8.34	7.25	8.15

Source: Bloomberg, Bank of Baroda Research, *Median Rate, Note: Shaded areas are rates lucrative for market borrowing

Table 2: AA, AA-, A+, A and A- can resort to bank borrowing for 10 Year basis

10 Year										
FY22	Gsec 10Year	AAA	AA+	AA	AA-	A+	A	A-	MCLR 1 year, PSBs	MCLR 1 year, PVBs
Apr	6.06	6.77	7.28	7.53	8.00	8.45	9.23	10.00	7.33	8.40
May	6.00	6.81	7.31	7.56	7.94	8.39	9.17	9.94	7.33	8.45
Jun	6.02	6.80	7.30	7.55	8.01	8.46	9.23	10.01	7.30	8.30
Jul	6.17	6.77	7.24	7.54	7.97	8.42	9.19	9.97	7.30	8.25
Aug	6.22	6.96	7.44	7.74	8.00	8.45	9.22	10.00	7.30	8.23
Sep	6.18	6.84	7.38	7.65	7.92	8.37	9.15	9.92	7.30	8.23
Oct	6.33	6.95	7.51	7.77	8.09	8.54	9.31	10.09	7.25	8.15
Nov	6.35	6.93	7.42	7.73	8.09	8.54	9.31	10.09	7.25	8.15
Dec	6.41	6.99	7.49	7.78	8.17	8.62	9.40	10.17	7.25	8.20
Jan	6.60	7.15	7.63	7.94	8.37	8.82	9.60	10.37	7.25	8.15

Source: Bloomberg, Bank of Baroda Research, *Median Rate, Note: Shaded areas are rates lucrative for market borrowing

It should be noted that the MCLR are the median rates and have been lower for PSBs compared with PVBs. The same has been done for 3 and 5 years bonds below.

Table 3: On FY basis, for 3 year paper/loans prima facie companies with ratings above A/A+ would get lower rates in the bond market. The others would have to go to banks.

3 Year										
FY22	Gsec 3Year	AAA	AA+	AA	AA-	A+	A	A-	MCLR 1 year, PSBs	MCLR 1 year, PVBs
Apr	4.84	5.17	5.67	6.03	6.86	7.31	8.08	8.86	7.33	8.40
May	4.72	5.10	5.62	6.00	6.61	7.06	7.83	8.61	7.33	8.45
Jun	5.03	5.22	5.71	6.05	6.68	7.13	7.90	8.68	7.30	8.30
Jul	5.15	5.26	5.76	6.12	6.73	7.18	7.96	8.73	7.30	8.25
Aug	4.63	5.26	5.77	6.08	6.64	7.09	7.87	8.64	7.30	8.23
Sep	4.88	5.17	5.69	6.01	6.53	6.98	7.75	8.53	7.30	8.23
Oct	5.05	5.42	5.89	6.23	6.76	7.21	7.99	8.76	7.25	8.15
Nov	5.11	5.52	6.01	6.20	6.86	7.31	8.09	8.86	7.25	8.15
Dec	5.18	5.64	6.11	6.33	7.00	7.45	8.23	9.00	7.25	8.20
Jan	5.31	5.78	6.30	6.51	7.19	7.64	8.41	9.19	7.25	8.15

Source: Bloomberg, Bank of Baroda Research, *Median Rate, Note: Shaded areas are rates lucrative for market borrowing

Table 4: On FY basis, bond markets would be better for AAA, AA+ and AA securities for 5 year paper

	5 Year									
FY22	Gsec 5Year	AAA	AA+	AA	AA-	A+	A	A-	MCLR 1 year	MCLR 1 year, PVBs
Apr	5.85	5.96	6.52	6.79	7.54	7.99	8.76	9.54	7.33	8.40
May	5.58	5.81	6.30	6.64	7.26	7.71	8.49	9.26	7.33	8.45
Jun	5.61	5.90	6.41	6.71	7.35	7.80	8.58	9.35	7.30	8.30
Jul	5.72	6.08	6.55	6.88	7.47	7.92	8.70	9.47	7.30	8.25
Aug	5.71	6.01	6.49	6.79	7.49	7.94	8.72	9.49	7.30	8.23
Sep	5.62	5.94	6.45	6.72	7.42	7.87	8.65	9.42	7.30	8.23
Oct	5.71	6.06	6.61	6.88	7.54	7.99	8.77	9.54	7.25	8.15
Nov	5.70	6.06	6.59	6.84	7.54	7.99	8.77	9.54	7.25	8.15
Dec	5.74	6.17	6.68	6.93	7.62	8.07	8.84	9.62	7.25	8.20
Jan	5.91	6.34	6.83	7.09	7.83	8.28	9.05	9.83	7.25	8.15

Source: Bloomberg, Bank of Baroda Research, *Median Rate, Note: Shaded areas are rates lucrative for market borrowing

Relevance of this exercise:

In a situation where Gsec bond yields are increasing the same gets reflected in the corporate bond yields. At the same time, we have seen that the MCLR will be driven more by the policy action of RBI. This revolves more on the repo rate. Now we have a situation where the repo rate has been held constant. But as Gsec yields increase, so would those on the higher rated bonds and bank finance will be advantageous.

Therefore, while corporate yields are expected to increase in FY23 the pass through to MCLR will be dependent on policy rate (repo), which will be more calibrated. Thus, for particular rating corporates, financing through bank channels may seem viable and banks may augment their credit demand through this route.

Looking back

Tables 5-6 provide a view on average cost for various rating groups for different tenure of securities over the full year with comparable yields on Gsec and MCLRs of banks.

Table 5: On FY basis, banks offered better rates for A and lower rated paper. In FY21, the pandemic year due to lower Gsec rates bond market was offering lower rates for A rated paper

	1 Year									
	Gsec	AAA	AA+	AA	AA-	A+	A	A-	MCLR, PSBs	MCLR, PVBs
FY17	6.64	7.41	7.69	7.90	8.20	8.80	9.35	9.60	9.25	9.58
FY18	6.38	7.19	7.39	7.57	7.77	8.40	8.96	9.38	8.45	9.00
FY19	6.97	8.29	8.57	8.77	8.87	9.54	10.17	10.73	8.62	9.23
FY20	5.77	6.84	7.22	7.45	7.68	8.13	8.91	9.68	8.43	9.27
FY21	3.78	4.59	5.18	5.41	5.64	6.09	6.86	7.64	7.47	8.69
FYTD22	4.06	4.34	4.77	5.14	5.86	6.31	7.08	7.86	7.29	8.25

Source: Bloomberg, Bank of Baroda Research, *Median Rate, FYTD22: Apr-Jan, Note: Shaded areas are rates better for market borrowing

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Table 6. On FY basis, banks would be preferred for funding if ratings were less than AA+

	10 Year									
	Gsec 10Year	AAA	AA+	AA	AA-	A+	A	A-	MCLR 1 year, PSBs	MCLR 1 year, PVBs
FY17	6.95	7.86	8.29	8.44	8.80	9.40	9.95	10.20	9.25	9.58
FY18	6.93	7.79	8.15	8.31	8.68	9.31	9.87	10.29	8.45	9.00
FY19	7.67	8.64	9.04	9.20	9.27	9.95	10.58	11.14	8.62	9.23
FY20	6.71	7.86	8.39	8.49	8.58	9.03	9.81	10.58	8.43	9.27
FY21	5.97	6.88	7.41	7.63	7.76	8.21	8.98	9.76	7.47	8.69
FYTD22	6.24	6.90	7.40	7.68	8.06	8.51	9.28	10.06	7.29	8.25

Source: Bloomberg, Bank of Baroda Research, *Median Rate, FYTD22: Apr-Jan, Note: Shaded areas are rates lucrative for market borrowing

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