RESEARCH

BOB Economics Research | Rate

Bond versus Bank finance - An analysis of rates

SUMMARY

India Economics: Rate

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.

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Daily macro indicators

Indicator	02-Feb	01-Jan	Chg (%)
US 10Y yield (%)	1.78	1.79	(1)
India 10Y yield (%)	6.88	6.85	4
USD/INR	74.84	74.80	(0.1)
Brent Crude (US$/bbl)	89.5	89.2	0.3
Dow	35,629	35,405	0.6
Hang Seng	23,802	23,550	1.1
Sensex	59,558	58,863	1.2
India FII (US$ mn)	**01-Feb**	**31-Jan**	**Chg ($ mn)**
FII-D	(90.1)	(42.4)	(47.7)
FII-E	(12.9)	(271.7)	258.9

Source: Bank of Baroda Economics Research

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RATES

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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.

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HOLD – Expected return from -6% to +15%

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Note: Recommendation structure changed with effect from 21 June 2021

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