Bond market or banks?

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The choice for any company when deciding on borrowing long term funds is between banks and the market. The cost of borrowing is one of the major factors influencing this decision. NBFCs are also an option but loans would tend to be priced higher as they borrow from banks and the market and have their mark-up on such funds.

The debt market is one for the higher rated companies as evidenced from the dominance of the AAA and AA companies in the total funds raised here. Typically, around 80% of total issuances go with a AAA rating while another 11-2% have a rating of between AA+ and AA+. Banks are more open to lending to non-investment grade companies (i.e. below BBB) as they have other considerations.

A question asked often is at what rating does the cost of borrowing for a company with investment plans tilt in favour of the market or banks. As a corollary we can get an idea of how much would be the average cost of borrowing for firms beyond a certain credit rating.

For this exercise, the 10-year corporate bond spread over the 10-year GSec is looked at for the 10-months period January to October to gauge how they have moved over time especially the covid period. The cost of borrowing is taken as the 10-year GSec benchmark yield plus the spread as calculated by FIMMDA.

Some interesting observations are:

- The yield on GSecs came down on a point to point basis by 72 bps while there were two spikes during this period. This was due to the market concerns on the government borrowing programme. The RBI had been inducing a lot of liquidity through this period through the OMOs, LTROs and TLTROs to ensure that rates were stable.
- The yield on AAA bond came down by 110 bps, AA+ by 89 bps, AA by 89 bps and AA- by 71 bps. However, the imputed yields for lower rated paper came down by a much lower rate.
- The spreads over GSec had come down from 99 bps to 61 bps for AAA paper and 127 bps to 110 bps for AA+ paper. For AA it was down from 154 to 137 bps. Hence there is a fairly high difference down the pecking order.

Average Yields on corporate bonds with maturity of 10 years (%)

	Gsec	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-
31-01-2020	6.60	7.59	7.87	8.14	8.42	9.42	9.92	10.42	10.67	10.92	11.17
28-02-2020	6.37	6.71	7.08	7.39	7.76	8.51	8.76	9.26	9.76	10.01	10.26
31-03-2020	6.14	6.95	7.27	7.67	7.87	8.87	9.37	9.87	10.12	10.37	10.62
30-04-2020	6.28	7.48	7.82	8.14	8.28	9.28	9.78	10.28	10.53	10.78	11.03
29-05-2020	6.01	7.22	7.67	8.04	8.42	9.42	9.92	10.42	10.67	10.92	11.17
30-06-2020	5.89	6.75	7.27	7.7	8.09	9.09	9.59	10.09	10.34	10.59	10.84
31-07-2020	5.83	6.58	7.09	7.47	7.87	9.37	9.62	10.37	10.62	10.87	11.37
31-08-2020	6.12	6.85	7.30	7.69	8.10	9.6	9.85	10.6	10.85	11.1	11.6
30-09-2020	6.02	6.77	7.26	7.54	7.99	9.49	9.74	10.49	10.74	10.99	11.49
29-10-2020	5.88	6.49	6.98	7.25	7.71	9.21	9.46	10.21	10.46	10.71	11.21

Source: FIMMDA

The table below gives the weighted average lending rate for fresh loans sanctioned during the month by banks for the period January to September. This has been given for different kinds of banks.

Table 2: WALR on new loans for banks (%)

Month	PSB	PB	FB	All
Jan	8.85	10.19	8.58	9.36
Feb	8.64	10.27	8.42	9.26
March	8.64	9.29	8.28	8.82
Apr	8.44	8.91	7.73	8.52
May	8.31	9.21	7.19	8.59
Jun	8.22	8.74	7.20	8.37
Jul	8.18	9.12	7.22	8.53
Aug	8.07	8.81	7.13	8.35
Sep	8.12	8.66	6.72	8.29

Source: RBI PSB: Public Sector PB: Private FB: Foreign

Table 2 shows that there has been a pattern in terms of the levels of lending rates (weighted) where it is lowest for foreign banks followed by PSBs. Private banks had the highest lending rates all through the period. The average for the system is between that of PSBs and private banks. This indicates that private banks have been lending more than the PSBs during this period which had pushed up the WALR for the system. Also, it is possible to say that the private banks had been lending relatively more to the lower rated companies especially during the pre-pandemic times at higher interest rates. PSBs had been focusing on the higher rated companies given that they were paying more attention to the quality of their portfolio given that their NPA rates had tended to be higher than those of private banks.

The differential between the WALR of these two sets of banks was 134 bps in January which came down to 54 bps in September. Clearly the private banks too had moved up the ratings curve when lending as they became more credit risk averse.

Where is the cost advantage?

Putting Tables 1 and 2 together one can look for the thresholds every month where the bond market yields were lower relative to the average WALR of banks. The WALR for all banks can be compared with the yields on different rated bonds which is presented in Table 3 below. The table shows that for all the months except February it was only the bracket of AA- and above that had access to the bond market at rates lower than the average bank lending rate. Companies with rating of A+ and below had to pay on an average higher rate in the bond market when raising money relative to banks. Bank borrowings on an average worked out cheaper.

Table 3: Corporate yields and WALR: Which is lower?

	AAA	AA+	AA	AA-	A+	A	A-	WALR
31-01-2020	7.59	7.87	8.14	8.42	9.42	9.92	10.42	9.36
28-02-2020	6.71	7.08	7.39	7.76	8.51	8.76	9.26	9.26
31-03-2020	6.95	7.27	7.67	7.87	8.87	9.37	9.87	8.82
30-04-2020	7.48	7.82	8.14	8.28	9.28	9.78	10.28	8.52
29-05-2020	7.22	7.67	8.04	8.42	9.42	9.92	10.42	8.59
30-06-2020	6.75	7.27	7.70	8.09	9.09	9.59	10.09	8.37
31-07-2020	6.58	7.09	7.47	7.87	9.37	9.62	10.37	8.53
31-08-2020	6.85	7.30	7.69	8.10	9.6	9.85	10.6	8.35
30-09-2020	6.77	7.26	7.54	7.99	9.49	9.74	10.49	8.29
29-10-2020	6.49	6.98	7.25	7.71	9.21	9.46	10.21	n.a.

Source: FIMMDA, RBI

An alternative way of looking at the same issue is to juxtapose the median MCLR (one year) with the corporate bond yields which presents a similar picture with a slight difference. The median MCLR has come down by 90 bps between Jan and October with 85 bps being witnessed between April and October. This can be attributed to the LTRO and OMO measures announced along with the repo rate cuts. Yields on AAA bonds were down by 110 bps and those of AA- by 71 bps.

Table 4 shows that in May and June the median MCLR was lower than bond yields up to the AA level. It was only in the AA+ and AAA levels that the bond market had better yields. This was repeated in August and September.

Table 4: Corporate bond yields vis-a-vis Median MCLR (One year) %

	AAA	AA+	AA	AA-	A+	A	A-	Median MCLR
31-01-2020	7.59	7.87	8.14	8.42	9.42	9.92	10.42	8.25
28-02-2020	6.71	7.08	7.39	7.76	8.51	8.76	9.26	8.21
31-03-2020	6.95	7.27	7.67	7.87	8.87	9.37	9.87	8.20
30-04-2020	7.48	7.82	8.14	8.28	9.28	9.78	10.28	8.00
29-05-2020	7.22	7.67	8.04	8.42	9.42	9.92	10.42	7.85
30-06-2020	6.75	7.27	7.7	8.09	9.09	9.59	10.09	7.68
31-07-2020	6.58	7.09	7.47	7.87	9.37	9.62	10.37	7.58
31-08-2020	6.85	7.30	7.69	8.10	9.6	9.85	10.6	7.45
30-09-2020	6.77	7.26	7.54	7.99	9.49	9.74	10.49	7.40
29-10-2020	6.49	6.98	7.25	7.71	9.21	9.46	10.21	7.35

Source: FIMMDA, RBI

The markets were more discerning in terms of being more open to the highest rated bonds and the yields reflected this sentiment.

But in general it can be seen that from the cost perspective it is only companies in the AAA and AA buckets which are able to raise funds at a lower cost for a 10 year period relative to borrowing from banks. The latter have been quite accommodative as has been seen with the median MCLR coming down by 90 bps during this period. This does not capture the inter-bank differential as the foreign banks had rates which were lower than the industry average.

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