Bond Market Growth - The Challenges

What is the issue?

\n\n

\n
- Better rated commercial entities are rapidly migrating to the bond market route for their credit needs.
\n
- Considering the shortfalls in our financial systems and the current stressed assets problem, there are multiple challenges in this trend.
\n

\n\n

What has caused the trend?

\n\n

\n
- Bank interest rates are not high enough to offer a real return (accounted for inflation) to depositors.
\n
- Hence, lately, much inflow has found its way to debt instruments like "Mutual Funds" that have given better returns than banks.
\n
- However, when it comes to credit, the situation is reversed, with banks charging higher rates than the bond market rates.
\n
- Therefore naturally, companies with strong balance sheets will move from banks to bonds in order to access cheaper finance.
\n
- This leads to a situation where banks are left to lend for companies with poorer credit ratings, which reduces the quality of their credit.
\n

\n\n

Is the trend bad?

\n\n

- \n
- Gap between bank lending rates and bond yields is not new, but it didn't matter in the past because restrictive rules for the bond market limited its size.
\n
- But lately, bond market volumes have been growing rapidly, and the share of banking funds the commercial sector has been dropping drastically.
\n
- Notably, while banks usually account for more than 50% of the commercial capital, the 2016-17 figures stood at a mere 38.4%, which was down from the previous year's number of 52.3%.
\n
- This situation is unlikely to have been reversed in the current financial year, due to the capital shortage in banks.
\n
- The problem of losing their best customers is particularly acute for the weaker banks that already face issues of credit quality and interest-rate spread.
\n

\n\n

What are the risks?

\n\n

- \n
- **Credit Crisis –** Increased non-banking sources of funds is actually good, and the need to develop the bond market like elsewhere was indeed stressed for long.
\n
- But as banks are currently seeking to improve their balance sheets as a priority, the loss of good commercial consumers would strain their lending calculations.
\n
- They would hence be forced to rely on safe retail lending (for housing, cars etc…), or on working capital loans that are backed by receivables.
\n
- Consequently, due to the absence of a strong 2nd tier of non-bank financial intermediaries, small and medium sector customers would be starved of credit.
\n
- **Investor Risk -** The rush to bond markets puts the spotlight on the "credit rating agencies", which influence the bond market yields with their ratings.

\n

- Typically, debt mutual funds that buy bonds manage to offer relatively attractive yields only by mixing up better rated instruments with poorer ones.
  \n
- Most retail customers investing in bonds due to better yields lack awareness that better yields come bundled with greater risk.
  \n
- As India’s financial systems enter into a new phase - Banks, fund managers, NBFCs, and rating agencies need to watch out for the new developments.
  \n

\n\n

\n\n

Source: Business Standard

\n