

Aligning banks and capital markets



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Financial markets in India comprise primarily the banking system and the capital market, if the government securities market is kept aside. Banks have been the mainstay of finance for the economy, though of late there has been a lot of interest shown in the capital market. The capital market is bifurcated into the equity and debt segments, both of which are regulated by SEBI. Banks come under the domain of RBI.

With continuous focus on spreading financial literacy, the public today is better aware of options in the market when it comes to savings. On the part of banks, there is now a quest to balance two challenges: garnering deposits at a time when the savers are savvier, and providing funds to borrowers who are still dependent on them. It is not surprising that banks do face a dual problem of garnering deposits and also managing their asset-liability balance as they end up financing infrastructure creation. The issue can be looked at on the mobilization of funds and their use from the banking perspective.

Bank deposits are the major source of funding of assets of banks. While 40% comes under what is called CASA, term deposits become challenging as savers become more market oriented. In the last few years, the equity market has witnessed a boom in both the primary and secondary segments. IPOs have been frequent which have been raised with high premia and while some have failed, most have listed at a higher than offer price thus offering very good returns. At the same time, with bank deposits rates

being kept low as the repo rate was lowered sharply last year by almost 125 bps (Feb 2025 to March 2026), individuals have been confident of dealing in the market directly.

In fact, some have been audacious to get into the F & O segment and made losses which prompted SEBI to intervene and control this unbridled enthusiasm. Those who have been less certain but willing to explore the market have invested heavily in the schemes of mutual funds. The icing on the cake was the tax benefits which went with equity gains compared with interest on deposits which is taxable at the card rate. All this has meant a migration of funds to the market, and while the position in FY27 so far till June has been favourable for banks due to the war leading to the markets being low, there can be a U-turn any time.

What can banks do? There needs to be a counter campaign run to assure customers that bank deposits provide an assured return, just like how the campaign on mutual funds have moved attention from bank deposits to capital markets. There could be advantage in reiterating this aspects as households have to take conscious decision when investing their savings. Communication is necessary more to educate individuals about options.

Second, banks need to come up with some product innovation because the present scheme of things lists card rates for various tenures and leaves it to the customer to decide the tenure and interest rate. These are plain vanilla products. The question is whether banks can mimic the market by providing a deposit with variable returns depending on market returns? Simply put, if deposits can be linked with a set of loans with say higher interest rates, given the risk profile, higher interest rates can be offered for the deposit. The rate can vary depending on the performance of these loans. Hence it will be analogous to the mutual funds which run schemes that look at say large or small cap companies and then give a NAV based on how these share prices move. Such schemes need to be devised to make bank deposits more attractive. A slight shift to changing the risk-return tradeoff can be experimented with by banks.

Third, on the part of the government there has been a proposal received from banks repeatedly to make interest on deposits tax free. This can be a big booster as bank deposits form the base of banking operations which allows several national objectives to be met. For example the SLR stipulation ensures that the government is assured of buyers for its paper when the fiscal deficit entails substantial market borrowings. Further, on the lending side, banks have to ensure that 40% of the credit given goes to the priority sector which has been defined by the government. This is besides the heavy lending which is directed to infrastructure. Ideally banks are not the right institutions for funding infrastructure given that deposits are normally at most for a period of 3 years while infra projects extend to up to 20 years. There is a clear asset-liability mismatch in terms of tenures of the two sides. Therefore the social use of deposits is very high unlike the capital market counterparts and there is a justification for providing this tax benefit. At least it can be brought on par with the tax rate on equities.

The asset side of banks also needs some attention and this is where the corporate debt market comes in. Prima facie, it has been seen that the debt market has seen progressively higher amount of issuances with almost Rs 10 lakh crore being mobilized in the last couple of years. However, a drill down shows that more than 2/3, and at times ¾ of these issuances, are by finance companies which use the funds for lending. There is not much going to the infra and manufacturing sectors. The reasons is that the market has some uncanny features which stand out from the way in which operates.

First, most borrowers are of high credit rating which can be AAA or AA. At times there are A rated companies, but it does not go down significantly. This is when the market is attractive as the yield is better than the cost of borrowing from banks. Once one goes down the rating hierarchy, bank loans tend to be cheaper and hence interest is low. This needs to change.

Second, if one looks at the major subscribers of debt, it is financial institutions. These are mainly insurance companies,

provident funds and pension funds. Now these companies are long term holders of paper and hence follow a policy of 'buy and hold'. Further as they deal with public money their preference is for higher rated paper. Therefore this supports the first point made that only highly rated companies borrow from this market.

Third, there is no easy route for selling paper after it is issued and purchased by investors. While there is a secondary market, it is hard to understand. Unlike a share of a company XYZ which can be bought anytime as it belongs to a company, for debt it is complex. The paper is issued for say 5 years and hence after 2 years, it is a 3 year paper. Besides one may not get a price as these securities are not actively trade. A 10 year bond of ABC will have a different interest rate (yield) from company XYZ even if the rating is same. Hence it is not like government bonds. Therefore retail interest is limited.

Some steps can be taken to make this market buoyant. First we need market makers who provide buy and sell quotes and these need to be provided incentives like access to cheaper credit or some regulatory forbearance so that they get interested. This way they can add liquidity to the market. This can be done for a certain set of securities to begin with.

Second, there is need to have a junk bond market where lower rated paper finds buyers. Junk bonds give higher returns but carry higher risk. Their default rate is not more than 3% in USA. This can be attractive for investors who are willing to take risk. But grooming such a market can take off some pressure from banks as these companies also tap the debt market.

Third, the credit default swap needs to be revived. This is a precondition to having a junk bond market. The reason is simple. The probability of default is high for some paper and to keep investor interest, some insurance is required which a CDS can do. It has to be revived and one way out is to make it mandatory for all issuances. This way there is a market which can be built which can in turn then cover even lower rated securities. In fact banks can provide this insurance cover for a fee.

Fourth, the tax benefits on debt have to be aligned with that on equity as there has to be an incentive to invest in such bonds. All this will mean the government having to go along with a slight drop in tax collections. But if we want to develop a market, there has to be a push given by the government.

Fifth, the resolution process to defaults has to be quick. While the IBC is in place for bank defaults, a similar structure has to be put in place for debt. Here a suggestion is that the government should set up a fund in the budget where the size increases every year. In parallel, it can be considered to have all debt issuances pay a contribution to the fund which can be 0.01% of the total size of issuance. Hence if Rs 10 lakh crore is raised in a year, Rs 1000 cr can be the contribution made to the Default cover fund in a year. It can further be drilled down to the rating accorded such that higher rated debt carry a lower fee. This will be a manageable cost for the issuers.

Hence there are steps that need to be taken keeping both the banking and capital market system in alignment. The two systems need to work in unison and for this there needs to be a level playing field for all participants. While rewards and risks vary across them given their intrinsic nature, the regulatory structures including taxation should be aligned to ensure there is less arbitrage.

There have been several steps taken by SEBI and RBI to grow the debt market and the fact that issuances have increased over the last decade is a testament of success. There are other issues to iron out that have been mentioned here which can be addressed in the near future. Banks on their parts should also work their way on the deposits front using innovation and communication to expand their base. The fact that the population is progressively getting more educated on the financial front should be leveraged to reach out with the right products by leveraging technology to grow business.

As the economy grows on a higher trajectory of 7-8% per annum in the next few years, the demand for funds would increase as investment picks up. While external markets are available access tends to get limited to the larger companies. It is here that the banking system as well as capital market have a critical role to play in providing the funds that are required. Until such time that specialized financial institutions and debt market evolve and mature, the onus will be on banks to continue to provide finance for infrastructure. There will surely be exciting times for the financial system as the journey on the high growth path takes off.

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