

The Evolving Interplay Between Commercial Banks and Capital Markets in India



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Few relationships in finance are as well documented as the one between a country's financial development and its long-run growth. Cross-country evidence shows that financial deepening, whether measured by credit-to-GDP, market capitalisation or the breadth of intermediation, improves how efficiently an economy uses its capital, and with it the pace of growth. As economies mature, the shape of their financial systems change and that shape matters.

In India our financial system has evolved around Bank credit with most Corporates using Debt as a leverage to expand. It is only now as we evolve that we see that the deepening of Securities market tilts the system towards market-based intermediation. This does not make Banking obsolete; it modifies the Bank's role from sole originator of credit to several roles as originator, underwriter, market-maker and liquidity backstop across the capital-market value chain.

Disintermediation and the Strategic Adaptation of Banks

In India, the 1991 liberalisation set this shift in motion, triggering a pronounced phase of disintermediation, the process by which savers and borrowers deal directly through the markets, bypassing the Banks that once stood between them. The clearest symptom was a financialisation of household savings: money that had sat in low-yielding deposits moved into mutual funds, equities and other instruments, eroding the deposit franchise Banks had long taken for granted.

Banks responded by reshaping their business around fee and other non-interest income and a far more active capital-market role. The larger institutions set up dedicated merchant-banking and securities arms, SBI Capital Markets being the obvious example, to house debt syndication, equity and debt capital-market (ECM and DCM) origination, IPO book-running and wealth management. As three-in-one savings, demat and trading accounts and digital onboarding spread, market access reached well beyond the big cities. The lesson has held up: in a liberalised economy, a Bank that turns lending relationships into capital-market mandates does not just survive disintermediation, it makes money from it.

The Symbiotic Relationship with Nonbanking Financial Companies

Few things show how deeply Banks sit within the wider system better than their dealings with Non-Banking Financial Companies (NBFCs). NBFCs specialise in last-mile lending the formal banking channel tends to overlook, in commercial-vehicle finance, gold loans, microfinance and used-asset financing, where local knowledge counts and thin credit histories defeat standardised underwriting. But by and large NBFCs suffer from a lack of a low-cost deposit base, leaving them at a structural funding-cost disadvantage to Banks.

To fund themselves, NBFCs rely heavily on wholesale markets, issuing non-convertible debentures (NCDs) and commercial paper (CP) to mutual funds and banks and borrowing term loans from banks. This may carry an asset-liability mismatch, with long-tenor loan books funded by short-tenor borrowings. In 2018, the default of a leading NBFC laid that fragility bare: as mutual funds stopped rolling over commercial paper, wholesale funding dried up and the sector faced a system-wide liquidity squeeze. Banks stepped in as the lender of penultimate resort, scaling up direct lending, buying out loan pools and, with the Regulator's help, channelling liquidity. The episode reshaped the operating model rather than ending the relationship: today the Bank-NBFC link runs through co-lending, priority-sector securitisation via pass-through certificates (PTCs) and direct-assignment pools, with Banks supplying Balance-Sheet capacity and priority-sector appetite while NBFCs supply origination reach. Through each cycle, Banks remain the system's shock absorber.

Deepening the Corporate Bond Market

Financing India's infrastructure pipeline and keeping growth high both need a deep, liquid corporate bond market. By developed-market standards the domestic market is still shallow: most issuance is via private placement rather than public offer, and demand bunches at the top of the rating curve. A deeper market would spread credit-concentration risk off Bank balance sheets, ease the fiscal burden of recapitalising stressed public-sector banks, and widen the funding base for long-gestation assets.

Banks are well placed to bridge these gaps. Because most corporate credit in India still originates within the Banking system, lenders hold a detailed, first-hand view of borrower creditworthiness that an arm's-length investor cannot match. On an originate-to-distribute basis, a Bank can credit-enhance an emerging issuer and bring it to the bond market as arranger and underwriter, while its treasury supports secondary-market liquidity through repo, market-making and buying when the market turns illiquid.

Regulators have also put bank balance sheets to work directly, through Partial Credit Enhancement (PCE), where a Bank provides a contingent, subordinated facility that lifts a bond's rating by several notches. By taking the first slice

of default risk, PCE makes otherwise sub-investment-grade paper acceptable to long-only investors such as pension funds, insurers and provident funds, whose mandates restrict them to higher-rated bonds. It deepens the bond market and lets banks recycle capital, since a funded loan becomes a contingent line that frees balance-sheet room for fresh lending.

A Watershed Moment in Acquisition Financing

The single biggest change now reshaping the Bank-market relationship is the regulatory go-ahead for Bank-led acquisition finance. For several decades the stance was one of structural caution: the Banking Regulation Act and successive RBI master directions effectively stopped Banks to lend against Equity or fund acquisition, to curb speculative leverage and keep depositor money away from buyout risk. In practice this pushed Indian acquirers towards offshore syndicated loans, external commercial borrowings (ECBs) and structured private credit from AIFs, often layered through holding companies.

That stance has now shifted. After a draft Capital Market Exposure framework in October 2025, the RBI on 13 February 2026 amended its Commercial Banks (Credit Facilities) and (Concentration Risk Management) Directions to let Banks finance corporate acquisitions, effective 1 April 2026, with earlier adoption allowed under a Board-approved policy. This is a watershed for domestic M&A and for how leveraged and management buyouts (LBOs and MBOs) are structured. A Bank can now lend up to 75 percent of an independently assessed acquisition value, to the acquirer or a special-purpose vehicle (SPV), secured by a pledge of the target's shares. The sponsor funds the remaining 25 percent from internal accruals or fresh equity, keeping genuine skin in the game, and the post-acquisition debt-equity ratio at the acquirer, SPV or target is capped at 3:1. The opening up comes fenced in by prudential safeguards - A Bank's aggregate capital-market exposure (CME) stays capped at 40 percent of its eligible capital base, on a solo and consolidated basis, with acquisition finance held to a sub-limit of 20 percent of Tier-1 capital, doubled from the 10 percent first proposed after consultation. Eligibility is tight: acquirers must clear net-worth and three-year profitability tests, unlisted targets must carry at least an investment-grade rating, valuations must rest on two independent appraisals, and banks must run stress-testing, early-warning and disclosure frameworks. The aim is to open a channel for strategic, value-creating consolidation while keeping out purely speculative financial engineering.

Completing the Architecture: Adjacent Regulatory Reforms

Allowing acquisition finance is necessary but not sufficient; the new rules will not realise their potential in isolation. For a genuine domestic leveraged-finance market to take root, regulators must still clear related frictions across insolvency law, the tax code and permissible capital structures. In mature markets a buyout is funded through a tranching capital stack: senior secured Bank debt sits at the top of the waterfall, cushioned below by subordinated or mezzanine instruments, often with payment-in-kind (PIK) features, that take the first losses before senior lenders are touched. Because current rules keep domestic Alternative Investment Funds (AIFs) from this junior-debt role at scale, that tranche usually heads offshore, into structures governed by foreign-law intercreditor arrangements. A purpose-built domestic AIF category for buyout finance, with diversification and concentration limits, would let Indian banks syndicate alongside transparent local co-lenders, share risk through enforceable intercreditor and subordination terms, and lean less on offshore shadow banking.

Conclusion

India's experience suggests the rise of capital markets does not make Banks less relevant; it redefines what they do. The story is one of evolution, not displacement. From absorbing the early shock of disintermediation to supporting the NBFC sector, Banks have reinvented their model time and again. They are now central to deepening the corporate bond market and, with acquisition finance live from April 2026, are set to become direct engines of corporate consolidation. The next stage turns on alignment, joining up Banking norms with the IBC, the tax code and capital-market regulation. The way forward looks very interesting and India can build on the existent resilient financial system to fund its long-term ambitions.