

RBI allows banks to pledge corporate bonds as collateral

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1

Small Business Ideas

2

Best Investments for Retirement

3

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Since these bonds carry higher risk than G-Secs, the RBI may impose haircuts



BL Research Bureau:

From a corporate bond market perspective, the RBI's slew of measures announced on Thursday can make the underlying market more liquid, improve intermediation and enhance corporates' access to global financial markets.

One of the key measures taken to improve demand and liquidity of corporate bonds is to allow banks to pledge corporate bonds with the RBI to borrow short-term funds.

The liquidity adjustment facility (LAF) allows banks to borrow money from the RBI under the repo window by selling government securities with an agreement to repurchase the same.

Now, banks can pledge corporate bonds too for borrowing funds under the LAF. Given that this may incentivise banks to buy corporate bonds, the increased demand will augment the liquidity in this market. But it is likely that the RBI will test waters with high-rated corporate bonds first.

Also, the RBI is likely to impose haircuts, given that these bonds carry credit risk which is absent in government securities.

For instance, the RBI may stipulate, say, a 7.5 per cent haircut, which means that if a bank pledges Rs. 100 crore worth of corporate bonds, it may only be able to borrow Rs. 92.5 crore under the LAF.

This will also automatically ensure that the yields price in the risk associated with the corporate bond. If a bank is able to borrow funds at 6.5 per cent (current repo rate) by pledging government securities, the effective cost while pledging corporate bonds (including haircut) will work out to about 7 per cent.

Good news for brokers

Brokers will now be allowed to act as market makers in corporate bond repos, which is good news for brokers. Brokers normally have a small balance sheet and hence, have low ability to underwrite operations.

But in the new mechanism the asset becomes self-funded. Once a broker, say, buys Rs. 100 crore of the asset, he can repo it out and borrow Rs. 100 crore and undertake another deal.

Banks being permitted to issue rupee-denominated bonds overseas (masala bonds) for their capital requirements is also a welcome move. Locally, the appetite for Tier-I and Tier-II capital bonds is low.

Globally, the more informed investors may find the yields attractive. This will help banks raise capital more easily.

The measures also include improving liquidity in semi-liquid government securities. From a longer standpoint the market making in government securities that the new measures propose, may work, depending on how much the RBI supports it.

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A primary dealer (PD) involved in market making will not want to be stuck with positions and will want the RBI to be actively doing switches. The RBI on Thursday indicated a combination of re-issuances and switches being planned.

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