Why state bonds are equal to some pvt sector debt in the market

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The covid-19 pandemic has been both a leveller and an inequality intensifier in the bond market. Even as it brutally differentiated between top-rated corporate paper and those with ratings below AA in terms of costs, it seems to have equalized some bond issuers.

On an average, state governments have borrowed at the same cost as AAA-rated private sector companies so far in FY22, a recent study by CARE Ratings Ltd pointed out.

"In the current financial year where the average cost for private AAA bonds and SDLs have been on par at 6.84%," analysts at the firm said in a note.

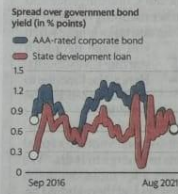
In essence, a sovereign paper with an implicit guarantee forked out an interest rate equal to a private sector entity to borrow from the bond market. This may seem counter-intuitive, but investors are not wrong in asking more from states.

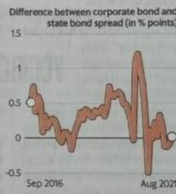
State development loans (SDLs), or bonds that state governments issue to borrow from the market, are considered sovereign but are, of course, priced at a spread over the central government paper.

The 10-year SDL yield is about 60 basis points (bps) above the corresponding 10-year government bond, not different from pre-pandemic levels. One basis point is one-hundredth of a percentage point. Liquidity surplus has grown exponentially since the pandemic. However, the surplus liquidity has brought down the cost of borrowing for top-rated private sector issuers in a big way. The 10-year AAA-rated corporate bond is priced at 65bps above the corresponding 10-year government bond yield. Pre-pandemic, this spread over the 10-year government paper was 100bps. The upshot is that corporate bond yields have crashed after the infusion of liquidity by the Reserve Bank of India (RBI). However, SDLs have hardly been able to get these benefits.

Same but different

On an average, state bond yield spreads have been similar to those of private sector corporate bonds in FY22 so far.





Source: Care Ratings

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Investors want states to compensate them for the weakness in their finances. State fiscal deficits have surged and so have state borrowings from the bond market since the coronavirus outbreak. States borrowed ₹8 trillion in FY21, which was 26% higher than the previous year.

The current fiscal year may not be very different as the second wave of the pandemic has kept up the pressure on revenues. State finances were hit by the goods and services tax (GST) arrangement with the Centre even before covid hit. The pandemic has only exacerbated the hit on revenues.

Surplus liquidity is likely to be constant here as RBI may not begin to tighten liquidity anytime soon. Therefore, for state bond yields to come down, it would take an improvement in overall state finances. The outlook for corporate balance sheets, especially of top-rated ones, continues to remain positive. The bond market would continue to favour AAA-rated issuers, while those with ratings AA and below may struggle.