

Yield-Driven Credit Substitution Favours Bank Lending

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Synopsis

- Rising capital market yields have tightened financial conditions through market channels faster than through bank lending rates. This divergence is encouraging corporates to substitute bond and money-market borrowing with bank credit.
- G-Sec yields have risen from ~3.8% (1Y) / ~6.4% (10Y) in March 2021 to ~7.0% across tenors by March 2026, with the increase largely concentrated at the short end, resulting in a relatively flat yield curve. This has substantially altered borrowing dynamics for both NBFCs and Corporates, with overall funding costs rising across the spectrum. NBFCs, particularly in AA and A categories, have been more affected by significant and persistent spread widening, even during periods of rate moderation. As a result, the cost advantage of Non-Convertible Debentures (NCDs) over bank loans has compressed significantly.
- AAA issuers continue to retain cost advantage, although the weighted average lending rate (WALR) and bond yield differential has narrowed significantly from ~473 bps (NBFCs) and ~490 bps (Corporates) in March 2021 to ~156 bps and ~168 bps, respectively, by March 2026. For AA-rated issuers, the differential has also moderated but remains positive, indicating that bond borrowing is still marginally cheaper than bank loans. In contrast, the differential for A-rated issuers have turned negative, making bond borrowing costlier than bank loans.

Divergence Between G-Sec Yields and Bank Lending Rates

Figure 1: G-Sec Yields (%)

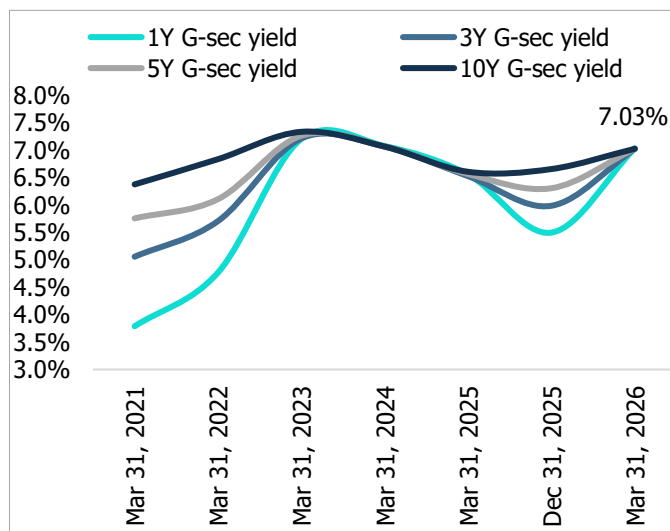
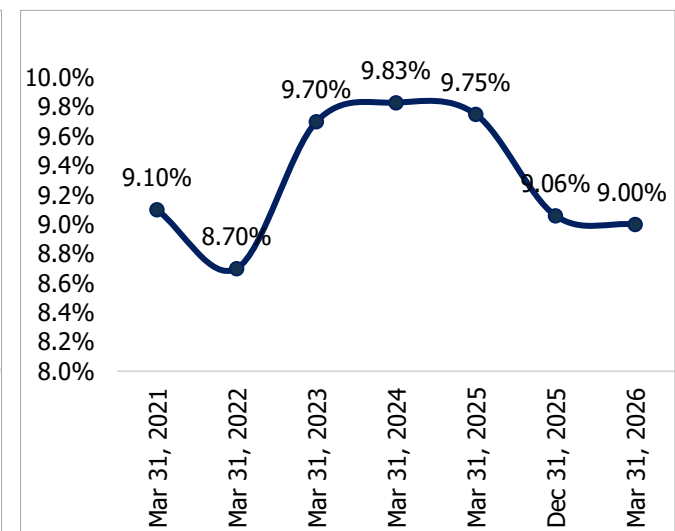


Figure 2: WALR O/s Movement (%)



Source: Refinitiv, RBI; Note: Yields are as of the respective month-end dates. The WALR outstanding rate for March 2026 has been considered based on the value reported for February 2026.

Government bond (G-Sec) yields rose sharply through FY23 amid the monetary tightening cycle, moderated during FY24–FY25, and edged up again by March 2026. The increase has been markedly sharper at the short end of the yield curve, compressing the term spread and materially flattening the yield curve. In contrast, banks' weighted average lending rate (WALR) on outstanding loans adjusted more gradually, peaking around FY24–FY25 at approximately 9.7–9.8% before easing to about 9.0% by March 2026, reflecting the inherently slower transmission

of policy rate changes to existing loan portfolios. This divergence underscores the higher volatility and faster repricing of market yields, compared with the stickier nature of bank lending rates. As a result, the spread between market yields and bank WALR has narrowed, eroding the earlier cost advantage of bond market borrowing and making bank funding relatively more competitive in the current environment. Higher volatility in market yields, alongside gradual adjustment in lending rates, is likely to continue influencing borrower behaviour, with issuers increasingly favouring bank funding over capital market issuance depending on market conditions and funding certainty.

From Bonds to Banks: Capital Market Volatility Re-anchors Corporate Borrowing in Banks as WALR–Bond Yield Gap Narrows, Eroding NCD Yield Advantage

Figure 3: WALR – Bond Yield Differential (bps)

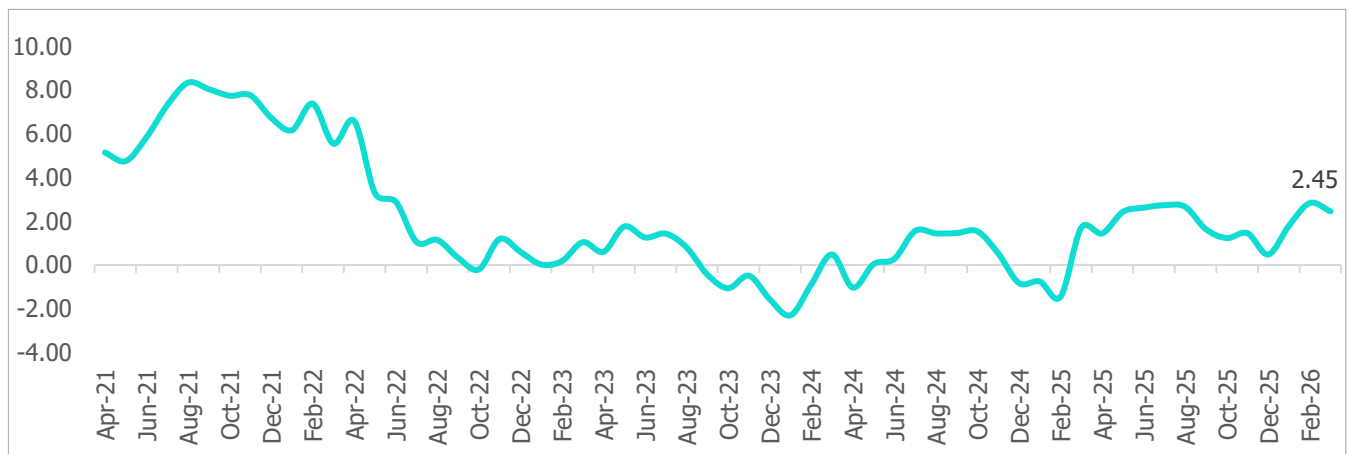
Segment	Mar 2021 WALR 9.10%	Mar 2022 WALR 8.70%	Mar 2023 WALR 9.70%	Mar 2024 WALR 9.83%	Mar 2025 WALR 9.75%	Mar 2026 WALR 9.00%
NBFCs						
AAA - 1 Year	473	360	169	187	216	156
AAA - 3 Year	352	270	186	199	209	154
AAA - 5 Year	285	186	188	201	215	143
AAA - 10Year	215	156	169	213	227	137
AA - 1 Year	358	275	94	125	143	56
AA - 3 Year	228	187	95	117	131	47
AA - 5 Year	182	101	89	123	132	36
AA - 10 Year	140	75	88	142	124	21
A - 1 Year	83	40	-146	-108	-62	-151
A - 3 Year	-50	-58	-148	-116	-74	-173
A - 5 Year	-80	-144	-150	-107	-76	-178
A - 10 year	-116	-160	-151	-94	-85	-204
Corporates						
AAA - 1 Year	490	360	160	201	239	168
AAA - 3 Year	364	279	171	211	254	181
AAA - 5 Year	305	201	158	223	257	159
AAA - 10 Year	225	168	171	230	261	149
AA - 1 Year	398	290	92	138	156	78
AA - 3 Year	293	207	101	153	170	91
AA - 5 Year	220	120	87	158	172	72
AA - 10 Year	153	90	101	155	169	63
A - 1 Year	183	100	-93	-42	-35	-111
A - 3 Year	80	15	-89	-32	-21	-101
A - 5 Year	-5	-72	-103	-29	-21	-118
A - 10 year	-60	-101	-91	-32	-27	-131

Source: RBI, Refinitiv; Note: Positive = Bank loans costlier - NCDs preferred, Negative = NCDs more expensive - Bank borrowing preferred; Note: Yields are as of the respective month-end. For March 2026, bond yields were calculated as the average of the Friday (weekend) yields for February 2026 and March 2026.

The cost advantage of NCDs over bank borrowing, as captured by the WALR–bond yield differential, has moderated between FY21 and FY26 for both NBFCs and corporates across ratings and maturities. The differential at the 1-year tenor has declined from elevated levels of ~473–490 bps in March 2021 to ~156–168 bps in March 2026, implying a ~65–70% compression. Despite this moderation, bonds continue to offer a meaningful cost advantage for AAA borrowers across tenors. For AA-rated issuers, the differential has also narrowed but remains positive across maturities. As of March 2026, AA-rated NBFCs retain a cost advantage of ~21–56 bps, while corporates maintain a spread of ~63–78 bps, significantly lower than the ~140–358 bps for NBFCs and ~153–398 bps range for corporates observed in March 2021. In contrast, A-rated issuers continue to face negative differentials across tenors, indicating that NCD funding is more expensive than bank borrowing. As of March 2026, A-rated NBFCs incur a cost disadvantage of ~151–204 bps, while corporates face an additional cost of ~111–131 bps. While longer-tenor (5Y–10Y) bonds continue to offer a cost advantage for AAA issuers, the preference for bond markets at these maturities is increasingly driven by diversification and access to long-term investors, rather than purely cost considerations. Overall, while the WALR–bond yield differential has compressed, reducing the relative attractiveness of NCDs at the margin, bonds remain cost-effective for AAA and AA issuers, whereas bank credit is more competitive for lower-rated borrowers, particularly A-rated entities.

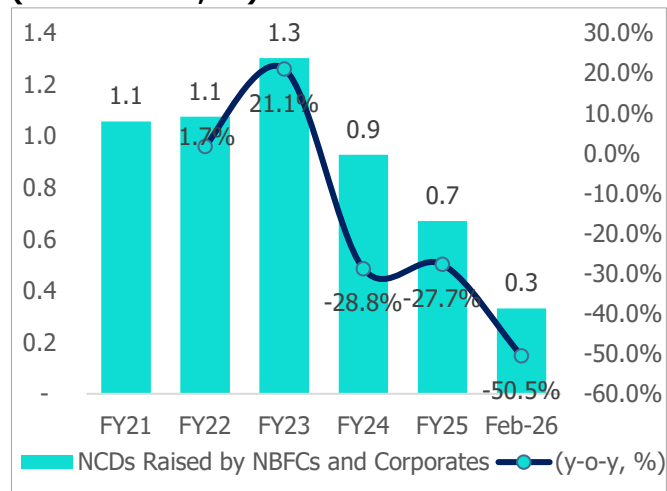
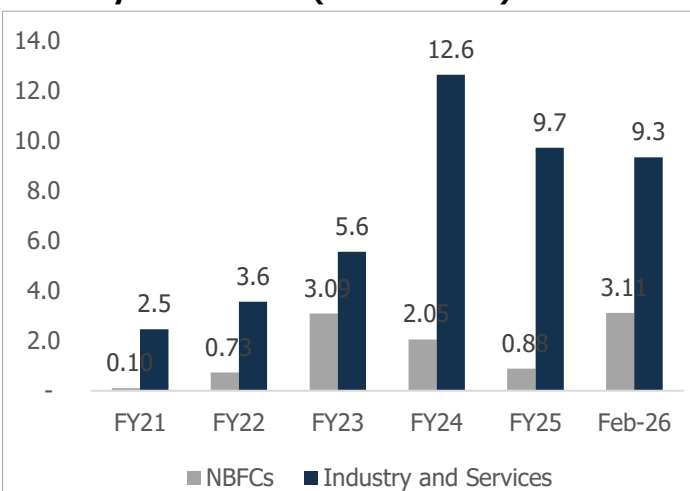
Liquidity Normalisation Alters Borrowing Dynamics

Figure 4: Movement in Monthly Outstanding Banking Liquidity (Rs lakh crore)



Source: RBI

System liquidity has played a key role in shaping borrowing patterns over this period. Following a surplus liquidity phase in FY21, conditions tightened and became more uneven from FY23 onwards, leading to higher short-term borrowing costs and wider credit spreads, particularly for lower-rated issuers. This has also led to situations in which elevated short-term rates, driven by tight liquidity and refinancing risks, have exceeded long-term yields, which are supported by strong institutional demand and expectations of future rate easing. Going ahead, if liquidity conditions remain tight or uneven, this trend is likely to persist, with issuers continuing to prefer bank funding over market-based borrowing, particularly for short-term requirements.

Figure 5: NCDs Raised by NBFCs and Corporates (Rs lakh crore, %)

Figure 6: Incremental Bank Credit to NBFCs, Industry and Services (Rs lakh crore)


Source: Refinitiv, RBI; Note: Industry and Services exclude NBFC

Between FY21 and FY26, the funding pattern for NBFCs and corporates shifted from bond markets to bank-led borrowing. NCD issuances rose steadily until FY23, peaking at Rs 1.30 lakh crore. Still, they declined significantly thereafter for three consecutive years to just Rs 0.33 lakh crore by FY26, reflecting a significant contraction in market-based borrowing. In contrast, incremental bank credit surged across segments, with lending to industry and services rising from Rs 2.5 lakh crore in FY21 to Rs 12.6 lakh crore (FY24), moderating in FY25, and standing at Rs 9.3 lakh crore by February 2026. Meanwhile, NBFC credit increased from Rs 0.1 lakh crore in FY21 to Rs 3.1 lakh crore by February 2026. This divergence highlights FY23 as a key inflexion point, after which rising interest rates, widening credit spreads, and increased investor risk aversion made bond-market borrowing less attractive, especially for lower-rated issuers. At the same time, the relatively gradual adjustment in bank lending rates and the stability of bank funding made it a more reliable and cost-effective source of finance. As a result, the earlier cost advantage of NCDs has largely eroded, leading to a sustained preference for bank borrowing. At the same time, the bond market has become more selective and supplementary, primarily catering to higher-rated issuers and longer-tenor funding needs.

Elevated Yields Push NBFCs Beyond NCDs

Between FY21 and FY26, NBFC borrowing costs have risen sharply, driven by both higher interest rates and widening credit spreads. AAA 1-year yields increased to ~7.4%, with spreads widening from ~56 bps to ~180 bps, indicating rising pressure on short-term funding. The impact is more pronounced for AA and A-rated NBFCs, where 1-year spreads have expanded to ~278 bps and ~485 bps, respectively, significantly increasing the cost of funds. The rise in yields is front-loaded at the short end, reflecting tighter liquidity and higher risk aversion. In contrast, the longer end remains relatively less volatile, especially for higher-rated issuers. However, in sub-AAA segments, elevated yields persist across the curve, limiting cost efficiency in bond-market borrowings. As a result, NBFCs are gradually reducing their reliance on NCDs, particularly in lower-rated categories, and shifting toward bank borrowings, private placements, and structured funding avenues. Overall, the bond market has become a more selective and supplementary funding source by FY26, particularly for sub-AAA issuers.

Borrowing Costs Surge for Corporations

Corporate borrowing conditions remain relatively stable for AAA-rated issuers. However, lower-rated corporates are facing significant cost pressures, with borrowing costs rising across all tenors. AAA 1-year yields have risen by around 300 bps to ~7.3% in March 2026. This has been accompanied by a sharp widening of spreads to ~166 bps, mainly due to pressure at the short end. In contrast, 10-year spreads remain steady at around 60 bps, supported by strong demand from long-term investors. For AA-rated corporates, 1-year spreads have increased to ~255 bps, pushing yields to above ~8.2%. A-rated issuers are under greater pressure, with yields crossing ~10% across all tenors and spreads nearing ~445 bps for 1 year and remain elevated at ~350 bps for 3-Y, 5-Y, and 10-Y, reducing the cost advantage of raising funds through bonds. The gap between WALR O/s and bond yields has narrowed for AAA-rated corporates but remains positive. For AA-rated issuers, the gap has reduced but bonds continue to be slightly cheaper. For A-rated issuers, the gap has turned negative, making bond borrowing more expensive than bank funding. Overall, higher yields and spreads have made bond markets less attractive, especially for lower-rated issuers. As a result, corporates are gradually moving toward bank loans and longer-term bonds, where borrowing costs are relatively more stable.

CareEdge Ratings View

According to Sanjay Agarwal, Senior Director, CareEdge Ratings, "The shift from bond markets to bank credit reflects a transitional transmission phase rather than an immediate weakening in credit quality. As capital market yields have risen and repriced faster than bank lending rates, owing to deposit repricing lags and relationship-based pricing, borrowers have increasingly shifted toward bank funding. This has supported liquidity and eased near-term refinancing, particularly for stronger corporates and NBFCs, while reducing execution risk from volatile market issuance. However, the shift also brings lower tenor diversification, greater exposure to floating rates, and higher reliance on banks. For lower-rated borrowers (below AA), bank lending rates typically include spreads over marginal or reference rates that increase as credit ratings decline (subject to asset-class and relationship dynamics), which can partially offset the relative disadvantage of bank borrowing compared with the bond market. Bond markets, on the other hand, provide additional liquidity and access to a broader investor base, particularly for longer tenors, including pension funds, mutual funds, and insurance companies. Additionally, if elevated rates persist and bank funding costs converge with bond yields, entities with weaker leverage or cash flows may face rising refinancing and margin pressures."

According to Saurabh Bhalerao, Associate Director, CareEdge Ratings, "India's debt funding landscape has shifted amid higher interest rates, wider credit spreads, and tighter liquidity, eroding and in some cases reversing the cost advantage of NCDs, particularly with A-rated issuers, while it has narrowed but remains positive for AA-rated issuers. This has pushed NBFCs and corporates toward bank borrowings, while bond markets have become more selective. For banks, this supports credit growth and near-term earnings, while lagged rate transmission helps contain immediate asset-quality stress. However, it also concentrates credit and duration risk on bank balance sheets and may pressure returns if lending rates lag funding costs. The divergence between market and bank transmission indicates tightening is being absorbed through pricing rather than credit contraction, implying that stress, if any, is likely deferred, with key risks hinging on funding stability, leverage, and the pace of rate convergence."

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