Floating Rate Bonds in Current Scenario 2022

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Current Interest Rate Scenario

The spiralling inflation across the globe has forced the central banks to put inflation ahead of growth. After the Bank of England, the US FED and the Reserve Bank of India, the European Central Bank too recently joined the league in hiking interest rates to spoil the low liquidity fuelled party which had been going on since the pandemic.

In the Indian context, the landscape surrounding fixed-income products has changed dramatically since the start of 2022. After persisting with a low-interest accommodative stance since 2020, the Reserve Bank of India is now in an inflation tackling mode. RBI has resorted to measures like hiking the repo rate and the Cash Reserve Ratio. These moves have already made a visible impact on the yield curves, especially in short-term papers and just about everyone expects more repo rate hikes in the coming MPC meetings. The Overnight Index Swap (OIS) has been factoring in more rate hikes this year.

Concerns over the recent rise in interest rates, and over the potential for rates to rise further, have led many investors to re-examine their portfolio allocations to diversified high-quality bond funds. Given the current scenario, fixed-rate bond prices have got affected due to rising interest rates, which makes investors worried or confused about their fixed-income investments. Against this backdrop, investors seeking alternative ways to protect against any rise in interest rates and to improve their portfolios' expected returns may consider floating-rate bond funds as one of the investible options. A trend that's truly visible now wherein the allocation of floating rate bonds by open-ended debt mutual funds is growing. This is now almost five times where it was a year back.

It is therefore important to understand floating rate bonds in depth to understand their benefits, the risks that it carries liquidity and how one can invest in these bonds.

What are Floating Rate Bonds?

Floating rate bonds are issued by financial institutions, corporations and governments to borrow money from the public. Now, unlike regular bonds that pay a fixed rate of interest, floating rate bonds have a variable interest which is linked to a predetermined benchmark rate and is reset at regular intervals. This benchmark can be anything ranging from the repo rate the reverse repo, the average table rate or some small savings scheme interest rate. Likewise, in international markets, possible benchmarks include the US Treasury note rate, the Fed funds rate, the LIBOR etc. So, essentially, if the prevailing benchmark rates are high, then these bonds pay a higher coupon and vice versa. These rates are reset on a periodic basis, which means there is no guarantee on your future income stream when investing in a floating rate bond. But having said this, an appropriate best time to own these bonds is when the benchmark interest rates are on the rise which is also the current scenario, hence the growing interest in floating rate bonds.

Benefits & Limitations

Much like any financial product these floating rate bonds have their benefits and limitations. In terms of advantages. Firstly, floating rate bonds are less volatile, as the coupons adjust to prevailing rate conditions. They generally offer high yields (as coupon resets go higher in rising rate scenario) as compared to other fixed-income instruments. Also in case the bonds are offered by the government, there is no credit risk in them. And finally, investing in floating rate bonds help investors diversify their portfolio amongst different categories within debt itself. So, to put it all together, a floating rate bond can be looked at as a less volatile, low credit risk (in case of sovereign issuance) and as a potential inflation hedge.

Now from limitations or concern standpoint, the most obvious one is the fact that there are no fixed returns and therefore your cash flows could be unpredictable. Secondly, the coupon that's received at periodic intervals are taxable as per one's income tax slab. Also, the coupon needs to be reinvested somewhere so there is some reinvestment risk. And finally, there might be an element of credit risk in corporate-issued bonds of varying degree depending on the nature of the issuer

Types of Floating Rate Bonds

Floating rate bonds (FRBs) are of many types. There are short-term floaters and long-term floaters, there are ones which are issued by the government, issued by corporates or financial institutions, ones that are callable bonds, non-callable etc. However, the overall construct of a floating rate bond is somewhat similar. Let's understand it with the help of an example. Now, the Reserve Bank of India issued a floating rate bond in 2020, which is popularly known as the RBI 7.15% bond. For the bond construct, the RBI pays the coupon and interest every six months, the rate of interest would be reset by the RBI on a half-yearly basis. The tenure of these bonds is seven years from the date of issue, and the benchmark for these floating rate bonds was 35 basis points or 0.35% higher than the interest rates offered under the National Savings certificate scheme. The current NSC interest rate is 6.8%. It used to be 7.9% in 2019, but over time, this number has come down as the RBI has brought down the interest rate So 6.8% plus 0.35% gives us an annualized interest rate of 7.15%. The 7.15% rate is applicable for the period January 1 2020 to December 31 2022 - post which the government shall take a decision on what the new interest rate should be for the next six months. Now, in addition to these floating rate bonds, the government of India has issued a few more, for example, they have issued FRB 2024, which uses the average implicit yields of the last three auctions of the government of India's 182-day treasury bills as its benchmark. As a consequence, the applicable interest rate for the six-month period from May 7 2022 to November 6 2022 shall be 4.41% per annum. Very recently, the government also issued INR 4,000 Crs of FRB 2028, which offers a 4.93% per annum interest rate for the half year from April 4 2022 to October 3 2022. As mentioned earlier that financial institutions and corporates can also issue floating rate bonds. While this method is not extensively used by Indian firms, we do see them slowly but surely leaning towards the floating rate option to meet the funding requirements. To put that into context, in 2019, the total issuance of floating rate bonds was INR 7,800 Crs, or ~ 1% of total issuances. However, in 2020, this percentage jumped to over 5%, which shows greater receptiveness amongst institutions and investors for floating rate bonds.

As stated earlier, floating rate bonds can be issued by governments, corporations or financial institutions. For investing in government-issued bonds for the first time one can look to subscribe to them by either of these two platforms that is the RBI retail direct account or the NSE GoBid platform. If you lack the expertise or find direct purchasing these bonds from the primary or secondary market complex then the mutual fund route could be the simplest route to participate in such bonds. Exposure to these bonds in funds comes with a self-adjusting feature which aligns itself to changing interest rates, making these bonds a viable option for anyone who's expecting the interest rates to go up or is uncertain of RBIs direction of interest rates. In fact, debt funds come with some prominent characteristics that are to their advantage. Firstly, these funds constitute a number of debt securities which keeps the portfolio diversified. They are open-ended schemes so you don't have to compromise on liquidity aspects.

Recently, the performance of sovereign FRBs has been under pressure due to the sustained supply of these bonds from government of India. However, with inflation still beyond the RBI's control leading to higher interest rates in the future, such events could be used by investors to initiate/increase exposure to FRBs and/or funds with FRBs as part of their portfolio. The next few coupon resets also could be on the higher side in the current scenario.