SHANKAR IAS PARLIAMENT
Information is Empowering

SEBI Rules for Debt Mutual Funds

Why in news?

The Securities and Exchange Board of India (SEBI), in its recent meeting, has tightened the rules for debt mutual funds.

What are debt mutual funds?

- There are different types of Mutual Funds that invest in various securities, depending on their investment strategy.
- Debt Mutual Funds mainly invest in a mix of debt or fixed income securities.
- These may include Treasury Bills, Government Securities, Corporate Bonds, Money Market instruments and other debt securities of different time horizons.
- Generally, debt securities have a fixed maturity date and pay a fixed rate of interest.
- The returns of a debt mutual fund comprises of -
    i. Interest income
    ii. Capital appreciation / depreciation in the value of the security due to changes in market dynamics

What is the rationale behind the new rules?

- Payment defaults by Infrastructure Leasing and Financial Services Ltd led to the liquidity crisis in India's shadow banking industry.
- Following this, mutual funds that had lent heavily to the non-bank lenders rushed to cut their exposure.
- However, mutual funds continue to have a massive Rs. 3.12 trillion exposure to NBFCs and housing finance companies.
- Given the uncertainty in this sector, the SEBI's rules now seek to de-risk liquid funds.
- The move aims at protecting investors from credit risks arising out of defaults by borrowers.
- SEBI's latest changes will have a significant impact on India's Rs. 25.93 trillion mutual fund industry.

What are the key changes?

- **Investment** - Liquid funds can invest a maximum of 20% of their assets in a single sector as against the current cap of 25%.

- [Liquid funds are debt mutual funds that can invest in securities up to a maturity of 91 days.]
- They must keep aside at least a fifth of their assets in cash equivalents to meet sudden redemption pressures.
- The mutual fund industry has to comply with the new sectoral caps from September 2020.
- [The changes are based on recommendations made by the mutual fund advisory committee constituted by SEBI to limit liquid fund exposure to a single sector.
- This is especially in reference to the non-banking finance companies (NBFCs) catering to the housing sector.]
- It will also be mandatory for all mutual fund schemes post September 2020 to invest only in listed non-convertible debentures and commercial papers.
- This measure is aimed at ensuring more transparency.
- Liquid and overnight schemes cannot invest in short-term debt and money market instruments, according to the new rules.
- **Credit-enhanced securities** - SEBI has reduced liquid funds' exposure to the credit-enhanced securities to 10% of AUM (assets under management).
- A credit enhancement is typically a promoter guarantee or the offer of shares as collateral in order to enhance the creditworthiness of specific debt paper.
- These are also referred to as loan against shares (LAS).
- The mutual fund industry currently has an exposure of around Rs. 50,000 crore to loans against shares.
- **Valuation** - SEBI has also finalized a uniform valuation policy for debt instruments.
- Currently, once the security falls below the investment grade, fund managers end up writing off papers as per their discretion.
- The new valuation framework plans to do away with this.
- Own trades or so-called self trades will also not be allowed to boost valuation of the paper.

Source: Livemint

Related News: Fixed Maturity Plans (FMPs) - Default, SEBI's New Rules on Liquid Funds