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NEW FRAMEWORK: ON SEBI'S NORMS FOR MUTUAL FUND INVESTMENTS

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Capital Market & SEBI

After introducing a new standard framework for credit rating agencies last month, the Securities and Exchange Board of India came up with more stringent regulations to govern the management of mutual funds. The mutual fund industry came under its scrutiny after some mutual funds in the last few months had to postpone redemption of their fixed maturity plans (FMPs). HDFC Mutual Fund and Kotak Mutual Fund came to grief and had to roll over or proportionately reduce redemption of their FMPs in April after some Essel group companies failed to redeem their non-convertible debentures where the funds had invested. According to the new SEBI regulations, liquid mutual fund schemes will have to invest at least 20% of their funds in liquid assets like government securities. They will be barred from investing more than 20% of their total assets in any one sector; the current cap is 25%. When it comes to sectors like housing finance, the limit is down to 10%. These measures are aimed to prevent situations such as the one being witnessed now. While the mandated investment in government securities will ensure a modicum of liquidity, the reduction in sectoral concentration will discipline funds and force them to diversify their risks. Some mutual funds entered into standstill agreements with companies in whose debt instruments the funds had invested. This is not a welcome practice and goes against the interests of investors in the mutual fund. SEBI has done the right thing by banning funds from entering into such standstill agreements. Further, SEBI has required that assets of mutual funds be valued on a mark-to-market basis in order to better reflect the value of their investments.

While SEBI’s intent to deal with the risks within the financial system is commendable, there could be unintended consequences to the regulator’s actions — which need watching. One of the new regulations introduced by SEBI is to increase the exit load on short-term investments in liquid mutual funds to discourage sudden demands for redemption. This could possibly hinder fund flow into the bond market, which in India is already quite undeveloped when compared to the rest of the world. While SEBI is doing a commendable job in disciplining the markets and intermediaries, the larger question is whether the regulator can really protect investors beyond a certain point. Market investments involve risk, and investors seeking high returns may in fact be willing to assume the increased risk that comes with such investment. That said, what the regulator is probably more concerned about is the ripple effect of defaults and roll-overs on the system. Investor confidence can be shaken by defaults and that will have consequences for the economy. Viewed from this perspective, the regulator’s latest rules should be welcomed.

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