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WIGGLE SPACE: ON SEBI'S NEW RULES

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

According to new regulations issued by the Securities and Exchange Board of India (SEBI), liquid mutual funds holding debt securities with a maturity term of more than 30 days will have to value these securities on a mark-to-market basis. Until now, liquid mutual funds could report the value of debt instruments with a maturity term of up to 60 days using the amortisation-based valuation method. Only debt securities with a maturity term of over 60 days were to be valued on a mark-to-market basis. So the new rule seemingly narrows the scope for amortisation-based valuation. Amortisation-based valuation, which is completely detached from the market price of the securities being valued, allowed mutual funds to avoid the volatility associated with mark-to-market valuation. SEBI’s new rules come in the midst of the crisis in Infrastructure Leasing and Financial Services (IL&FS) that led to various fund managers reporting the value of the same debt instruments issued by the infrastructure lender at vastly different levels. The chief financial markets regulator believes that mandating mutual funds to report the value of a greater share of their holdings on a mark-to-market basis can lead to a better and more objective valuation of these securities.

By exempting securities with a maturity period of up to 30 days from mark-to-market valuation, however, SEBI may be doing no favour to individual investors. This is because the new SEBI rule gives a strong incentive for liquid mutual funds to invest more of their funds under management in securities with a maturity period of fewer than 30 days; this helps avoid the volatility of mark-to-market accounting and the need to provide a fair account of the value of their investments. What is likely is a decrease in the yields received on securities maturing in 30 days or less and an increase in the yields on debt instruments with a maturity period of 31 to 60 days. It will, however, do nothing to make investors in mutual funds become more informed about the real value of their investments. The latest SEBI rules are also in direct contrast to the usual accounting practices when it comes to the valuation of securities. Generally accepted accounting principles mandate securities with the least maturity to be reported on a mark-to-market basis while allowing the amortisation-based method to be employed to value other securities with longer maturity periods. This makes sense as the profits and losses associated with securities with shorter terms are closer to being realised by investors when compared to longer-term securities. SEBI would do well to mandate that all investments made by liquid mutual funds should be valued on a mark-to-market basis. Simultaneously, it should work on deepening liquidity in the bond market so that bond market prices can serve as a ready reference to ascertain the value of various debt securities.

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