

## **SEBI CHAIRMAN'S ADDRESS AT 25<sup>th</sup> AGM OF AMFI**

**September 22, 2020; Mumbai**

1. Ladies and Gentlemen, a very good morning to all of you. I would like to thank AMFI for giving me this opportunity to address their 25th AGM. Leaving aside the limitations of a virtual mode of address, I will try to share my thoughts with you on the Mutual Fund industry at this crucial time.
2. But before that, let me begin with complimenting AMFI for the good job it is doing. One of the most challenging tasks that a regulator faces while adopting a consultative approach to policy making, is building consensus amongst various stakeholders. Not only is AMFI effectively providing a two-way communication between the regulator and the mutual fund industry, it is also taking various initiatives including efforts to bring in standardization within the industry, especially with regards to processes.
3. This being an annual event which I am addressing for some time now, in today's address, I would like to briefly cover the status of the markets as a whole, the performance of the Mutual Fund industry and the major policy initiatives taken by SEBI during the last one year, before moving on to the present issues and challenges faced by the industry along with the possible ways to address them.

### **A. Introductory Remarks:**

4. The world today is passing through a phase of unprecedented uncertainty which none of us witnessed in our lifetime. Financial markets across the globe have been severely affected ever since the declaration of COVID 19 as a

pandemic around mid – Mar' 20. The worst part is that the uncertainty continues and no one knows for how long it would last.

5. The Volatility Index (VIX) in Indian stock market went up significantly to 84 in Mar '20 from average of 15 in previous 3 months i.e. Dec '19 - Feb '20. For the first time in the history of Indian stock market, lower circuit breaker got triggered on two occasions within a short time span of two weeks during Mar '20.
6. To curb volatility and to ensure orderly functioning of the market, SEBI took several surveillance measures in Mar'20 which are still in force. This, along with various measures taken by the Government and RBI brought calmness in the market. The VIX has now come down to around 20.
7. The good news is that, despite uncertain times, the overall fund raising through the capital markets during this financial year has been quite encouraging. The overall funds raised up till 18<sup>th</sup> September 2020 were INR 5.0 lakh crore (INR 1.46 lakh crore in equity and INR 3.54 lakh crore in debt securities). As for a comparison with the last year, till end August, total funds raised this year were about INR 4.5 lakh crore as compared to INR 4 lakh crore last year. This is particularly important since corporate India needed to build a cushion of capital to absorb the COVID shock and the markets have lent full support to help them do that.
8. As far as the performance of mutual fund industry is concerned, overall, the industry has weathered the storm well which demonstrates the robustness of the regulatory framework as well as the maturity of the industry.

9. The Mutual Fund industry, however, also went through several patches of challenges, especially on the debt mutual fund side. Some of the issues that arose during the period are now addressed and some are in the process of being addressed. The contemplated policy measures inter-alia include stress testing, minimum asset allocation in liquid assets and a swing pricing like mechanism.
10. Such events also force us to think if there is a need for some structural changes in the system. In this context, I would like touch upon the two recent initiatives taken by SEBI – for setting up a special purpose clearing corporation for repo in corporate bonds; and for setting up a back-stop facility for improving liquidity in the secondary market for corporate bonds particularly during periods when liquidity tends to dry up. You being a critical part of this industry and the eco system have been giving many constructive suggestions on the same and we look forward to your playing a central role in making these initiatives take root and become successful.

**B. Industry performance:**

11. If one takes a look at the track record of the mutual fund industry's growth during the last five years, one can easily say that the industry has shown robust growth.
12. From March 2015 to August 2020, the asset under management (AUM) of the industry has grown by 154% from INR 10.83 lakh crore to INR 27.49 lakh crore. During this period, while the AUM of debt schemes increased from INR 6.94 lakh crore to INR 13.89 lakh crore, AUM of non-debt schemes increased from

INR 3.89 lakh crore to INR 13.60 lakh crore. The number of mutual fund folios increased by 122% from 4.17 crore to 9.26 crore during the same period.

13. At an industry level, there has been net positive inflow of funds in mutual funds during each of the previous five financial years averaging at INR 1.89 lakh crore each year. The figure for this financial year till August 2020 is INR 1.99 lakh crore.

14. To increase penetration of mutual funds beyond the top cities, SEBI started incentivizing mutual fund investments from beyond top 15 cities and later from beyond top 30 cities. However, the share of B-15/B-30 cities in the total industry AUM has hovered around just 15-17% over the last four years. We need to strive more to make mutual funds popular in areas beyond top 30 cities.

15. In terms of scheme performance, SEBI had introduced the concept of benchmarking to Total Return Indices to bring greater transparency in respect of how well various schemes have performed. We look forward to the Industry working hard to outperform relative to these benchmarks to deliver value to its investors.

### **C. Policy initiatives:**

16. Liquid Schemes of mutual funds account for a very large proportion of all debt-oriented schemes. To enhance the risk management framework for Liquid Schemes, they were mandated to hold at least 20% of their AUM in liquid assets such as Cash, Government Securities, T-bills and Repo on Government Securities. The valuation of debt and money market instruments is now done fully on mark to market basis instead of amortization. Further, Liquid and

overnight schemes are not permitted to invest in short term deposits, debt or money market instruments having structured obligations or credit enhancements.

17. Prudential norms governing investments in debt and money market instruments were also changed. Mutual Fund schemes have been mandated to invest primarily in listed debt securities (including CPs), which is being implemented in a phased manner. All investments in equity shares by Mutual Fund schemes shall only be made in listed or to be listed equity shares. The cap on sectoral limit of 25% has been reduced to 20%. Prudential limit on total investment by a Mutual Fund scheme in debt and money market instruments having credit enhancements is prescribed at 10% and investment by a Mutual Fund scheme in such debt securities of a particular group, has been capped at 5%. Investment in debt instruments, having credit enhancements backed by equity shares directly or indirectly, shall have a minimum cover of 4 times considering the market value of such shares.

18. AMCs have been mandated to undertake Internal Credit Risk Assessment on a continuous basis and also need to be well equipped to generate early warning signals on deterioration of credit profile of the issuer. All AMCs shall publish on their respective website a list of their group companies and those of their sponsor(s).

19. Valuation of money market and debt securities being an important aspect, SEBI has advised the industry to align with best practices. Some of these alignments include updating the definition of non-traded money market and debt securities

and modifying the provision for valuation of money market and debt securities with both put and call options.

Further, in order to bring uniformity and consistency in valuation, a waterfall approach for valuation of money market and debt securities has been adopted by the industry through valuation agencies appointed by it. Considering that as per the Principles of Fair Valuation, AMCs are responsible for ensuring fairness of valuation and correct NAV, AMCs are permitted to deviate from the valuation price given by the valuation agencies, subject to appropriate documentation of rationale and disclosures.

20. For facilitating price discovery in a transparent manner and improving liquidity in Corporate Bonds market, SEBI has mandated that at least 10% of Mutual Fund's total secondary market trades in Corporate Bonds need to be done by placing quotes through one-to-many mode on the Request for Quote (RFQ) platform of stock exchanges. Further, all transactions in Corporate Bonds and Commercial Papers where in Mutual Funds are on both sides of the trade shall be executed through RFQ platform of stock exchanges in one-to-one / one-to-many mode.

**D. Issues faced by debt mutual funds:**

21. Let me now dwell upon the challenges faced by the industry on debt mutual funds side and how those challenges are being addressed.

22. In March-April 2020, significant risk aversion and subsequent illiquidity was observed in the bond market especially in AA and below rated papers. This created significant challenges in the form of redemption pressures being faced

by debt Mutual Funds, on account of not only normal year end redemptions, but COVID related redemption pressures. That experience brought to fore not only the structural issues related to the corporate bond markets but also revealed some areas of improvement in respect of the practices followed in the mutual fund industry.

23. SEBI has followed a multi-pronged approach to address these issues. On one side, while SEBI has made, and is deliberating, policy changes to address the areas of improvement in the mutual fund industry, on the other side, it has initiated structural reforms to alleviate the problem of illiquidity in corporate bond market especially in non-AAA rated papers.

24. One of the areas for improvement is to enhance the liquidity of the portfolio of open-ended debt mutual fund schemes. While portfolios of equity-oriented schemes are fairly liquid, same may not be the case with all debt-oriented schemes. While overnight schemes are primarily invested in liquid assets such as G-Secs, T-bills, repo in G-Sec and cash, and there is a provision for Liquid schemes to hold minimum 20% in liquid assets, the other debt-oriented schemes currently have no such requirement and can invest in various categories of corporate bonds, CPs, CDs, whose secondary markets may not have enough liquidity.

25. Recently, during the period of increased illiquidity in the corporate bond market, there were requests from the debt mutual funds to permit them to include G-Secs and T-Bills in the core asset allocation of Credit Risk Funds, Corporate Debt Funds and Banking and PSU Debt Funds to meet the

heightened redemption requests. While the same was allowed as a temporary measure, SEBI is facilitating the setting up of an expert committee:

- to frame a stress testing methodology, encompassing liquidity, credit and market risks, for all open-ended debt oriented mutual fund schemes; and
- to design a framework to determine the minimum asset allocation required in liquid assets, taking into account the nature of scheme's assets, type of investors, outcome of stress testing, minimum redemption requirement during gating, etc.

In the interim, taking into account the recommendations made by the Mutual Fund Advisory Committee, SEBI would be stipulating a minimum holding of liquid assets by all debt-oriented schemes.

26. Another issue that got highlighted was the possible impact of large redemptions on remaining unit holders of a scheme. In case of any scheme witnessing large redemption requests, and with not so liquid instruments as assets, there are high chances that more liquid assets get liquidated first and the scheme is then progressively left with a relatively more illiquid portfolio. This benefits exiting investors at the cost of those who continue to stay particularly in case of stressed situations.

27. The proposed expert committee will also examine liquidity risk management tools such as "Swing pricing / Anti-dilution levy" for passing on transaction costs to the transacting investors. The tools will apply to both the incoming and outgoing investors, thereby protecting the interest of existing investors.

#### **E. Tackling illiquidity in corporate bond markets:**

28. Mutual funds as institutional investors are one of the largest holders of corporate bonds. Mutual Funds constantly see inflows and outflows to/from schemes. Therefore, Mutual Funds also contribute a significant share in the secondary market trading in corporate bonds and CPs. But under many scenarios when there are industry-wide trends of subscriptions or redemptions, it becomes difficult for Mutual Funds to get a sizeable counterparty to cater to their buying/selling needs. Thus, there is a pressing need to increase liquidity in the corporate bond market to ensure smooth functioning of the debt mutual funds.

29. Apart from mandating mutual funds to do a minimum percentage of their secondary market trades in corporate bonds on the RFQ platform of stock exchanges, SEBI is pursuing a multitude of measures to not only increase liquidity in secondary markets but also to enable greater issuances of paper rated below AAA. Some of the measures include –

30. Repo in corporate bonds – A liquid repo market using corporate bond collateral has the potential to greatly enhance demand for corporate bonds, as well as secondary market liquidity in corporate bonds, as many investors who do not consider corporate bonds due to their illiquidity could have access to low cost funds collateralized by their corporate bond holdings. Market makers in corporate bonds needing access to low cost capital as well as securities to cover their short sales would also be able to carry out their market-making operations more cost efficiently in the presence of a liquid repo market in corporate bonds. As per the latest European Repo Market Survey of

International Capital Market Association, in December 2019 corporate bonds as collateral had a 17.3% share in the total Euro 8.3 trillion outstanding repo contracts in the books of 58 participating institutions.

31. In India, the repo market on corporate bonds has unfortunately not taken off till now. SEBI is deliberating on having a limited purpose central clearing corporation for guaranteed settlement of tri-party repo trades in all investment grade corporate bonds, including those below AAA rated, to boost repo trading in corporate bonds. As major holders of corporate bonds, the mutual funds, who regularly have buying/selling needs, would be one of the biggest beneficiaries of a liquid market. Issuers will also be significant beneficiaries of a liquid and stable market in terms of lower borrowing costs.

32. Back-stop facility – An entity which can trade in relatively illiquid investment grade corporate bonds and be readily available in times of stress to buy such bonds from various market participants in the secondary market, may instill greater confidence of market participants in corporate bonds, especially in below AAA investment grade bonds. SEBI is examining the setting up of such a backstop facility in consultation with various stakeholders. Of course, as a broad general guiding principle, for any such entity to be set up, the market participants should have ‘skin in the game’ and the ‘moral hazard’ problem ought to be satisfactorily addressed.

#### **F. In the end, some advice**

33. Though the industry has grown at an outstanding pace over the last few years reflecting the confidence of investors in mutual funds, there is a need to

continue upholding this confidence for the mutual benefit of the industry and the investors it serves.

34. Protecting the interest of investors is the primary duty of mutual funds, and thus all decisions that funds take on behalf of investors should be taken keeping in mind the best interest of the investors. The debt mutual funds must remember at all times that there is a difference between 'Investing' and 'Lending'. Mutual funds are not banks and shouldn't attempt to behave like one. Unlike banks there are neither capital adequacy requirements for mutual funds nor do they have the 'lender of last resort' comfort as banks have from RBI. The true reflection of their portfolio in its NAV on daily basis is the cornerstone of transparency and investors' trust.

35. I have been told that 46 mutual funds have over 1700 schemes. SEBI, in consultation with the industry, had done a mammoth exercise in 2017 and come out with categorization of schemes in 36 categories. Improper categorization of schemes will only lead to confusion amongst the investors apart from the possibilities of mis-selling. Scheme category and its performance vis-à-vis benchmark are major inputs based on which investors decide whether to invest in a scheme or not. If a scheme portfolio is not true to its label, it might be giving very different risk return exposure to the unit holders of the scheme than what they have signed up for. SEBI norms for categorization of mutual fund schemes have two objectives – that the scheme portfolio should reflect the name of the scheme; and that the scheme performance can then be compared against an appropriate benchmark. The funds need to keep their scheme portfolios true to their label.

36. While various policy measures have been, and are being taken to facilitate continuous improvement, the recent experiences have once again shown that there is no alternative to prudent risk management. I hope the industry is able to live up to the expectations of the investors in carrying out its fiduciary responsibility towards them. This is in the interest of the growth of the industry too.

37. I wish AMFI and the mutual fund industry all the best in these challenging times.

Thank you.