Should MFs call for Direct RBI Support?*

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Franklin Templeton (FT) has shut down six of its debt funds with an aggregate AUM (assets under management) of Rs. 25,856 crore (as on April 2020). Faced with such a situation, there are clamours for support from Reserve Bank of India to specific players of the mutual fund industry. In the current financial meltdown arising out of the pandemic, globally, central bank's liquidity support is being used to help various financial institutions to keep them afloat. In this regard, the RBI is no exception.

Apart from providing liquidity support to banks, the RBI has opened a special liquidity facility (SLF) for the MFs of Rs. 50,000 crore on April 27, 2020. This package is on-tap and open-ended. Under this new package, the RBI shall conduct repo operations of 90 days tenor at a fixed repo rate.

Funds availed of under this scheme will be used by banks exclusively for meeting the liquidity requirements of MFs for: extending loans; and undertaking outright purchase of and/or repos against the collateral of investment-grade corporate bonds, commercial papers (CPs), debentures and certificates of deposit (CDs) held by MFs.

With liquidity support availed of under the SLF-MF being eligible for classification as held to maturity (HTM) even in excess of 25 per cent of total investment permitted under the HTM portfolio with exposures under this facility being reckoned under the large exposure framework, the RBI has been quite liberal in its scheme. Furthermore, support extended to MFs under the SLF-MF are exempted from banks' capital market exposure limits.

Reportedly, market players are not satisfied with such a package. In the midst of the pandemic, when a substantial amount of money is being parked by the banks under the reverse repo, they fear commercial banks may not be keen to lend to the MF industry. Perhaps there are expectations that the RBI could have directly intervened and helped the MF industry, like the US Fed buying toxic assets from various financial institutions.

After all, Section 18 of the RBI Act, 1934 empowers the RBI to have exceptional power to purchase, sell or discount any bill of exchange or promissory note though such bill or promissory note is not eligible for purchase or discount by the Bank under Section 17. But are these expectations justified?

The FT case

To use the FT case as an example, all the six suspended schemes of FT are open-ended debt funds. These funds were invested in sub-AAA rated bonds of listed and unlisted companies. The underlying investment philosophy was to generate a higher return by taking higher risks. Most of these funds have been there for more than a decade, and they managed to generate better returns than their peers for most years since their inception. However, some of these funds were facing difficulties since the IL&FS crisis and the current pandemic only aggravated their problems.

Given the nature of these funds and the investment strategies followed, it is surprising that there is an appeal for an RBI bailout. It is well known that for lower-rated bonds, Indian debt market can get illiquid intermittently. There can also be solvency issues with these types of bonds. The fund managers knowingly take these risks to generate higher returns.

A press release by SEBI indicates that some debt mutual funds have been warned for investing in inherently illiquid unlisted debt securities, particularly in securities in which only a single investor invested. SEBI suggested that such investments suffer from opaqueness of structure and risk and they lack disclosure in respect of financials of the issuer.

Guidelines ignored

Consequently, SEBI issued a circular (dated October 1, 2019) asking the mutual funds to limit their exposure on such bonds. However, the SEBI press release categorically pointed out that despite the regulatory guidelines, some mutual fund schemes chosen to have high concentrations of risky, unlisted, opaque, bespoke, structured debt securities with low credit ratings.

Therefore, it is clear that some fund managers and fund houses have ignored regulatory guidelines and have knowingly taken undue risks to generate higher returns. While achieving higher historical returns can be a means to attract more investors, it can also be a typical case of a principal-agent problem where the fund managers' compensations are linked to short-term performance matrices. In such cases, government bailouts may encourage such errant behaviour and dubious investment decisions. This can damage the regulator's reputation and credibility, compounding moral hazard issues in future.

Moreover, debt funds are generally favoured by corporates and HNWIs. Such knowledgeable investors surely would have evaluated the risk-return trade-off before investing in such high-risk funds. It is well known that credit risk debt-instruments can have both liquidity and solvency risks, and any economic disruptions can create significant problems for investments in lower-rated bonds.

Also, the total size of the FT funds facing immediate redemption constraints is not very large compared to the total AUM of the Indian mutual fund industry. Therefore, the possibility of a systemic risk emanating from the suspension of these funds is rather low.

Interestingly in the specific case of FT, the parent, Franklin Templeton is one of the world's largest global investment managers. Therefore, it is surprising that the parent has not chosen to rescue its offspring and failed to give temporary liquidity support to the investors of these six funds, which could have been a trifle for such a behemoth?

To state the obvious, the RBI in deciding its rescue package needs to distinguish between a liquidity risk and a solvency risk. It is unfair to expect that RBI would come to the rescue of some specific funds facing illiquidity on account of their own folly. This demand for bailout of specific funds sounds awfully like what Stiglitz categorised as socialisation of losses and privatisation of gains. In their offer documents, MFs mention, “Mutual fund investments are subject to market risks — read the offer document carefully”. It is high time we increase the font size of such statutory warnings.

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