Review of Risk Management Framework of Liquid Funds, Investment Norms and Valuation of Money Market and Debt Securities by Mutual Funds

1.0 Objective:

This Board memorandum proposes to amend SEBI (Mutual Funds) Regulations, 1996 [MF Regulations] and circulars issued thereunder, governing risk management framework for Liquid Funds, prudential norms for Mutual Fund schemes for investment in debt and money market instruments and valuation of money market and debt securities by Mutual Funds.

2.0 Background:

2.1 The default on debt obligations by IL&FS group in September, 2018 and subsequent volatility in the debt and money market instruments issued by various NBFCs and HFCs had resulted in redemption pressures in debt mutual fund schemes, more specifically in liquid schemes, while the net inflows to the industry were also reduced. From an analysis of Asset under Management (AUM) of open-ended debt oriented schemes, it is observed that the AUM declined from Rs.12,12,687.43 Cr. as on 31st August, 2018 to Rs.9,92,980.45 Cr. as on 31st October, 2018 i.e. a decline of around 18% over a period of 2 months.

2.2 In case of liquid and money market schemes the AUM had declined by around 25% during the said period of 2 months. This was despite the fact that the total exposure of Mutual Fund schemes to the IL&FS group was only approx. INR 5,200 Cr. (including debt issued by SPVs of IL&FS) as on 31st August 2018 i.e. around 0.35% of the debt AUM of the Mutual Fund industry. Similarly, the AUM of liquid and money market schemes had declined from Rs. 5,09,156 Cr. as on January 31, 2019 to Rs. 4,36,223.60 Cr as on March 31, 2019 i.e. a decline of around 17% during the two month period of Jan-March 2019. This was despite the fact that the total exposure of Mutual Fund schemes to business groups facing certain stress which came to light during this period, was very low as compared to Total AUM of debt schemes.

2.3 During such period, it was noticed that to meet the redemption requirements, in most cases the more liquid assets in the portfolios were sold first and thus the remaining investors exposure to lesser liquid instruments increased. Further, during the downgrade of various debt securities, it was observed that there were different valuation practices across Mutual Funds. The percentage of haircut applied across Mutual Funds to such securities had varied with a wide range. There was also variation in when these haircuts have been applied. Such practice may also have resulted in first mover advantage with certain investors taking advantage of the gap between the credit event and date of taking the haircut, by redeeming at a higher NAV.

2.4 While it has been 9 months since the crisis in IL&FS, the AUM of open ended debt schemes is yet to reach the AUM levels seen at the end of August 2018 i.e. Rs. 12,12,687.43 Cr. The corresponding AUM as on May 31, 2019 stands at Rs. 11,70,250.21 Cr.

2.5 After the recent turmoil and consequent default by certain issuers on their debt obligations, concerns have also been raised with regard to mutual fund exposure in debt and money market instruments having structured obligations (SOs) or Credit Enhancements (CE) in the form of pledge of shares, Non Disposal Undertakings (NDUs), related party transactions, corporate/ promoter guarantee, conditional and contingent liabilities, and through various other complex structures. In respect of rating of structured finance products, namely instruments / pay-outs resulting from securitization transactions, SEBI had mandated certain disclosures and standardized the rating symbols by using SOs, but the 'SO' affix is used in ratings of instruments other than securitized or asset backed transactions. In this regard, SEBI vide a recent circular to CRAs had prescribed a separate suffix of 'CE' (Credit Enhancement) to rating of instruments having explicit credit enhancements.

2.6 The IL&FS event and the subsequent crisis being faced by few business groups highlights that a credit event in even one or a few issuer/group could lead to significant liquidity risk in the entire industry. Thus, it becomes imperative to take necessary steps to safeguard the interest of investors, maintain the orderliness and robustness of mutual funds and financial markets.

3.0 Review of Risk Management Framework of Liquid Funds

3.1 Extant Regulatory Framework For Risk Management

3.1.1 As per SEBI circular dated October 06, 2017, liquid and overnight funds have been defined as –

Liquid Fund - Investment in debt and money market securities with maturity of up to 91 days only.

Overnight Fund – Investment in overnight securities having maturity of 1 day.

3.1.2 **20-25 Rule**: To reduce investor concentration in schemes, the existing regulatory framework has mandated that each scheme needs to have a minimum of 20 investors and no single investor shall account for more than 25% of the corpus of the scheme.

3.1.3 **Portfolio Disclosure Norms**: Mutual Funds (MF) disclose portfolios (along with ISIN) as on the last day of the month / half-year for all their schemes on their respective website and on the website of AMFI within 10 days from the close of each month/ half-year respectively.

3.1.4 **In-house Stress Testing:** All AMCs are required to conduct stress testing for all liquid funds and money market schemes at least on a monthly basis. As part of stress testing, AMC are required to test the impact of interest rate risk, credit risk and liquidity & redemption risk, among others as deemed necessary, on the NAV of the concerned schemes. Further, in the event of stress test revealing any vulnerability or early warning signal, AMCs are required to bring it to the notice of the trustees and take corrective action.

3.1.5 **Credit Risk Assessment:** To avoid undue reliance on credit rating agencies, MFs/ AMCs are required to conduct in-house credit risk assessment before investing in fixed income products.

3.1.6 **Restriction on Redemption:** In the event of systemic crisis or events that severely constricts market liquidity or the efficient functioning of markets, restriction on redemption can be imposed in a transparent manner, subject to certain conditions such as market wide crisis, force majeure events, etc. Specific approval of Board of AMCs and Trustees is required before imposing such restrictions.

3.1.7 **Borrowing Limits**: MFs in India are not allowed to borrow for investment purpose. They can temporarily borrow to a limited extent i.e. 20 percent of the net assets of the scheme for a maximum period of 6 months, only to meet temporary liquidity requirement.

3.1.8 **Prudential Limits**: In order to limit credit risk exposures of schemes, limits as a percentage of net assets of scheme have been placed on securities issued by a single issuer (10%), single group (20%), single sector (25%), that are unrated (25%), etc. Mutual Funds in India are not permitted to invest in securities rated below investment grade. Further, the limits w.r.t single issuer and single group may be further extended to 12% and 25% respectively subject to the approval of trustees.

The sector level limit excludes investments in Bank CDs, CBLO, G-Secs, T-Bills, short term deposits of Scheduled Commercial Banks and AAA rated securities issued by Public Financial Institutions and Public Sector Banks.

Further, an additional exposure to financial services sector (over and above the sectoral limit of 25%) not exceeding 15% of the net assets of the scheme has been allowed by way of increase in exposure to AA rated securities of Housing Finance Companies (HFCs), subject to the total exposure to HFCs not exceeding 25% of net assets of scheme.

3.1.9 **Fair Valuation**: To ensure fair treatment to all investors – existing, subscribing or redeeming investors, the overarching and overriding principles of Fair Valuation have been adopted that requires all MFs to value underlying assets of the scheme at their realizable value.

3.1.10 **Time period for payment:** To ensure that the AMCs do not have to immediately liquidate instruments to pay for redemptions, a time period of 10 days has been provided under MF Regulations for payment to investors.

3.2 Need for review

3.2.1 The AUM of liquid and overnight schemes as on May 31, 2019 stands at approx. INR 5.5 Trillion which is more than 20% of the total AUM of the mutual fund industry and more than 40% of the debt scheme AUM. Liquid schemes play a significant role in the overall investment portfolio of various investors. Liquid schemes also play a significant role in providing short term funds to various issuers through investments. Sudden redemption pressure in liquid schemes can have cascading effect across various sectors and may impact the confidence of investors in the industry.

3.2.2 The recent events as detailed at paragraph 2.0 highlights that credit event in even one or a few issuer/group could lead to significant liquidity risk in the entire industry and affects the confidence of the investors.

3.2.3 In this background, it becomes imperative to review the risk management framework with respect to liquid and overnight schemes and for investments in various debt securities.

3.3 Recent measures taken by SEBI in wake of credit events

3.3.1 **Segregated Portfolios in Mutual Fund Schemes:** In order to ensure fair treatment to all investors in case of a credit event and to deal with liquidity risk, SEBI has permitted creation of segregated portfolio of debt and money market instruments by MF schemes subject to certain conditions.

3.3.2 **Valuation of money market and debt securities:** In order to make the existing valuation practices more reflective of the realizable value, SEBI has inter-alia mandated:

a. All money market and debt securities which are rated below investment grade shall be valued at the price provided by valuation agencies.
b. Till the agencies compute the valuations, such securities would be valued on the basis of indicative haircuts provided by the valuation agencies.

c. The residual maturity for amortization based valuation has been reduced from existing 60 days to 30 days.

Further, AMCs may deviate from the indicative haircuts and/or the valuation price for money market and debt securities rated below investment grade provided by the valuation agencies subject to certain conditions and adequate disclosures.

3.4 <u>Consultative process and recommendations</u>

A working group representing AMCs, industry and academia was constituted to review risk management framework with respect to liquid and overnight schemes and for investments in various debt securities. The recommendations of the working group was taken up for deliberation in the Mutual Fund Advisory Committee (MFAC) meeting held on June 19, 2019. The recommendations of MFAC are broadly in line with the recommendations made by the working group and are detailed below:

3.4.1 **Minimum investments in liquid instruments:** In order to deal with sudden unplanned redemptions in liquid schemes, MFAC has recommended investing a minimum % of AUM in 'liquid instruments'. Cash, Government securities, T-bills and Repo on G-Securities are considered as 'liquid instruments'. Towards this end, MFAC observed that in a stress scenario, the average net redemption in liquid schemes is approx. 19% and the average investments of Top 5 investors in schemes is approx. 20%.

Recommendation: In view of the above, MFAC has recommended that liquid scheme should invest at least 20% of its net assets in liquid instruments. Cash, Government Securities, T-bills and Repo on G-Securities may be considered as Liquid instruments. In case if the minimum investment in such liquid instrument falls below the above threshold, additional investments by the scheme should first be made towards meeting the shortfall for investments in such liquid instruments before making any other investments.

3.4.2 **Sector Concentration:** The present regulations permit MFs to take enhanced exposure to the financial sector as compared to the other sectors. This has allowed MFs to build up concentrated portfolios in this sector, thereby, making them over-exposed to the risks faced by the financial sector. This concentration of the MFs' portfolio over a single sector or sub-sector may give rise to increasing risk to single sector.

Recommendation: In view of the above, MFAC recommended the following:

i. Reduce the sectoral exposure limit of 25% and additional exposure of 15% for HFC in two stages:
   - Stage I - The sector limit may be reduced to 22.5% and the limit for HFC may be reduced to 12.5%.
   - Stage II - The sector limit may be reduced to 20% and the limit for HFC may be reduced to 10%

ii. All existing investments may be appropriately grandfathered. However, they would be subject to other investment norms.

iii. The above limits may be applicable to all debt schemes.

MFAC further recommended that SEBI may like to consider an additional 5% exposure for investment in securitized debts based on retail housing loan portfolio and affordable housing loan portfolio over and above the HFC limit.

3.4.3 **Valuation**: MFAC had noted the recent SEBI circular on reducing the residual maturity for amortization based valuation from existing 60 days to 30 days. The Net Asset Values (NAVs) of Mutual Fund schemes should move closer to their realizable market value, so as to ensure fair treatment to all investors and reduce the incentive to large investors to take the first mover advantage by redeeming during tight liquidity situations.

Recommendation: In view of the above, MFAC has recommended that valuation of debt and money market instruments based on amortization may be dispensed with and may completely shift to mark to market valuation w.e.f. April 1, 2020.

3.4.4 **Investment in structured obligations:** MFAC observed that in order to chase higher returns certain liquid schemes had invested in structured obligations exposing the investors to higher risks. However, the objective of liquid schemes is to provide reasonable returns at a high level of safety and liquidity through judicious investments in high quality debt and money market instrument.

Recommendation: In view of the above, MFAC has recommended that liquid and overnight schemes should not be allowed to invest in debt securities having structured obligations and credit enhancements. However, debt securities backed by government guarantee may be excluded from such restriction.

3.4.5 **Exit Load:** MFAC noted that certain investors invest and exit from liquid schemes within a very short period. Thus, managing liquidity for such investors, impacts the returns to investors who stay invested in the scheme for a longer period.

Recommendation: In view of the above, MFAC has recommended that Mutual Fund should levy exit load on investors who exit the schemes in a short period. To ensure uniformity across the industry, it is further recommended that exit load should be charged for upto 7 days and SEBI may decide the appropriate rate in this regard.

3.4.6 **Short Term Deposits:** Currently, the mutual fund schemes are permitted to invest in short term deposits pending deployment of funds. The maximum tenure for such investments shall not exceed 91 days. Considering the purpose of liquid schemes and overnight schemes there may not be a need to deploy money in short term deposits and they may invest their additional funds in CBLO or other liquid instruments.

Recommendation: In view of the above, MFAC recommended that liquid and overnight schemes may not be permitted to invest in Short Term Deposits.

3.4.7 **Cut-off time for subscription:** MFAC noted that liquid schemes are permitted to allot units based on NAV of the previous day in case if the application for subscription and funds are received before 2:00 pm. The fund managers of liquid scheme can deploy the funds in CBLO till 2:30 pm. The entire activity of finalising the surplus fund for investments in CBLO and thereby investing has to be completed in a short span of 30 minutes. This leads to operational risks.

Recommendation: In view of the above, MFAC has recommended that the threshold for applicability of NAV for subscription in liquid and overnight schemes may be reduced from the existing 2:00 pm to 1:30 pm and SEBI may review the same from time to time.

MFAC has recommended that appropriate time period may be given to industry before effecting the aforesaid changes. However, SEBI may decide the appropriate time period for implementation of each of the aforesaid recommendations.

3.5 <u>Proposal</u>

3.5.1 The recommendation of MFAC at paragraph 3.4.1, 3.4.3, 3.4.4, 3.4.6 and 3.4.7 above may be accepted.

3.5.2 The recommendation of MFAC at paragraph 3.4.2 may also be accepted with the following stage wise implementation:

<u>Stage I -</u> The sector limit may be reduced to 22.5% and the limit for HFC may be reduced to 12.5% with additional 2.5% exposure for investment in securitized debt based on retail housing loan portfolio and affordable housing loan portfolio.

<u>Stage II -</u> The sector limit may be reduced to 20% and the limit for HFC may be reduced to 10% with additional 5% exposure for investment in securitized debt based on retail housing loan portfolio and affordable housing loan portfolio.

Further, the revised investment norms at sector level may be made applicable to all new schemes and for fresh investments by existing schemes. Existing open ended mutual fund schemes may be required to comply with the revised investment norms at sector level after giving sufficient time so that there is no sudden selling pressure. Further, the existing close ended schemes may not be required to sell their investments to comply with the investment norms. However, if existing close ended schemes sell their investments then their fresh investments shall be subject to the restriction. This shall be in line with the earlier decision of SEBI when the limits were previously reduced.

3.5.3 The recommendation of MFAC at paragraph 3.4.5 may also be accepted. However, the appropriate rate of exit load may be decided in consultation with industry participants to bring in uniformity.

3.5.4 The proposals at paragraph 3.4.1, 3.4.2 and 3.4.3 may be made effective w.e.f. April 01, 2020. The proposals at paragraph 3.4.4, 3.4.5, 3.4.6 and 3.4.7 may be made effective for all prospective investments within one month from the date of issuance of the circular.

4.0 **Review of investment norms for mutual funds for investment in Debt and Money Market Instruments**

4.1 **Extant regulatory norms for investment in debt securities**

4.1.1 As per the existing norms (in terms of Regulation 43 of SEBI (Mutual Funds) Regulations 1996 (MF Regulations), Mutual Funds are, inter alia, permitted to invest in debt and money market instruments including privately placed debentures.

4.1.2 The various investment and prudential norms for investments by Mutual Fund schemes in debt securities, with regard to limits on single issuer, single sector, group exposure and unrated debt securities as per Seventh Schedule under Regulation 44 (1) of MF Regulations and various circulars issued thereunder, have been detailed at paragraph 3.1.8 above.

4.1.3 Furthermore, in respect of investment by Mutual fund schemes in unlisted equity shares, clause 11 of the seventh schedule of MF Regulations states that a mutual fund scheme shall not invest more than 5% of its NAV in the unlisted equity shares or equity related instruments in case of open ended scheme and 10% of its NAV in case of close ended scheme.

4.2 **Need for Review:**

4.2.1 On account of the background as detailed at paragraph 2.0 and specifically paragraph 2.5 above, the investments of mutual funds in debt and money market instruments of various promoter group entities were analyzed. From the analysis, it was observed that generally the issuer of debt, is a private limited company controlled by the promoter(s) of a prominent listed company. The debentures issued by such private limited companies are indirectly backed by the promoter(s) either in the form of pledge of debenture of a group / promoter company or direct pledge of shares of group company or through covenants/ NDUs without pledge of shares, personal or corporate guarantee, credit enhancements, etc.

4.2.2 In certain cases there were be-spoke transactions between the issuer and the mutual fund scheme and the terms of such investments were not disclosed and also not known to other market participants. Thus, there was lack of transparency and disclosure of the terms of investments and there were instances where the debt securities were rated above investment grade due to SOs/ CEs. However, on standalone basis the rating of those securities based on the financials of the issuer company may not be rated above investment grade.

4.2.3 Trustees of mutual funds were advised to review investments by mutual fund schemes in debt and money market instruments by promoter group entities and through other SOs (including CEs). Upon perusal of the reports of the Trustees, some of the major recommendations of trustees for Asset management Companies (AMCs) inter-alia are mentioned below:

a) Limits on maximum exposure to promoter group entities as percentage of scheme AUM.

b) Limits for investment restrictions (for debt securities) on investment in unrated securities, in rated securities not rated below ‘A-’, in securities backed by pledge of unlisted securities, etc.

c) Reporting of the adverse change in credit quality, if any, to the investment Committee/ Board of Directors/ Board of Trustees.

d) Policy for immediate reporting of breaches of critical covenants and the terms and conditions as per the term-sheet to the investment committee.

e) Monitoring of adequacy of cover in case of secured debt instruments on continuous basis. Analysis on the details of number of days required to liquidate the collateral and to make the same part of the investment note.

f) Restrictions on investment through be-spoke structure in debt securities having SOs.

g) Mechanism to monitor the combined issuer wise exposure at the guarantor level.

h) Processes and parameters should be defined and documented, identification of instruments/ securities issued by promoter group entities, which are complex in nature or raised through SOs (including CE), requiring enhanced due diligence such as legal vetting, approval from the Company’s Risk Team, etc. to cover market risk, liquidity risk etc., for consistent investment execution of such asset class.

The proposals made in the instant Board memorandum also considers the various recommendations of trustees to their respective AMCs.

4.3 **Analysis of data regarding MF investments in Debt and Money Market instruments having Structured Obligations or Credit Enhancements.**

4.3.1 Data was collected from all the AMCs with respect to investments made by mutual fund schemes in all debt and money market instruments issued by all entities which raised funds through various complex structures like related party transactions, corporate/ promoter guarantee, conditional and contingent liabilities, covenants, pledge and/or NDUs of shares, structured obligations, etc. as at the end of month for the time period July 2018 to April 2019. Following are observed pursuant to analysis of the MF industry data regarding investment in debt and money market securities backed by SO/CE:

a) At the MF industry level the total investment in debt securities having SOs/CEs is in the range of Rs 89,000 Cr. to Rs 1,03,000 Cr.

b) At the aggregate level, investments in debt securities having SOs/CEs comprise 11% to 15% of the total debt portfolio of schemes that have investment in SOs / CEs.

c) The share of investment in listed debt securities having SOs/CEs is between 37-47% of the total investment in SOs / CEs.

d) Investment in Debt securities having SOs/CEs backed by equity comprises between 23% to 28% of total investment in such debt securities backed by SO / CE.

e) For MF schemes investing in debt securities backed by SOs/CEs, on an average around 14.80% of the AUM of scheme (or 16.46% of debt AUM) is invested in debt securities backed by SOs/CEs. The respective median values are 10.23% and 12.10%.

f) With respect to exposure to debt securities backed by SOs/CEs of a single issuer, on average the schemes have an exposure of 6.39% of scheme AUM with median value of 3.92%. The same comprises on an average 7.11% of debt AUM with a median value of 4.5%.

g) Exposure to debt securities backed by SOs/CEs of a particular promoter group is on an average at 7.73% of scheme AUM with a median value of 5.84%. The same comprises 8.57% of debt AUM of schemes with median value at 6.66%.

h) An indicative number of average equity cover based on data provided by AMCs is 1.50 times. The same is based on cumulative investment in a particular debt security (based on ISIN) across various schemes of AMCs.

4.4 **Observations on MF investments in Debt and Money Market instruments having Structured Obligations/Credit enhancements vis-à-vis extant regulatory provisions.**

4.4.1 The MF Regulations are silent on the requirement of investments of mutual fund schemes in debt securities being listed or not. From analysis of industry data, around 20% of investments in value terms are invested in unlisted debt securities. Further, money market instruments such as CDs and CPs are currently not listed.

4.4.2 The MF regulations place a limit on exposure of mutual fund schemes at issuer level as a percentage of scheme AUM. However, MF Regulations are silent on the aspect of concentration of mutual fund schemes to a particular issue, in other words a particular scheme can even subscribe to an entire debt issue as long as single issuer limit is adhered to. The same has enabled investment by mutual funds through be-spoke structures.

4.4.3 Mutual fund investments in debt and money market instruments through various structured obligations (SO) or with Credit Enhancements (CE) are mostly by way of private placement and the rating of those securities are based on external credit support rather than based on the fundamentals of the issuer.

4.4.4 Schemes having exposure to debt securities backed by SOs/CEs on an average have an exposure of less than 17% of debt AUM with median value of around 12%. Therefore, having an overall limit (maximum exposure limit) would ensure the necessary discipline pertaining to investment in SOs/CEs by MF schemes in the medium term without causing much industrywide disruption.

4.4.5 RBI prescribes a minimum cover of 2 times the Loan value for loan against pledge of shares. Considering that Mutual Funds are largely expected to have exposure to high quality debt instruments, and also the fact that unlike Banks, Mutual funds do not have the cushion of statutorily prescribed minimum risk capital, if at all investment into structured obligations backed by equities is to be permitted, the cover must be sufficiently large keeping in mind the inherent volatility in equities.

4.4.6 In addition to the above, it may also be pointed out that MF Regulations permit investments by Mutual Fund schemes only in investment grade debt securities, it is likely that these entities create such complicated structures to garner high rating so that MF Regulations may be complied with. It is noted that most of the debt issuances are rated AA and above. In many cases such ratings are apparently given on the basis of direct/indirect support of promoter group entities, as the issuing entity on its own may not command such high ratings.

4.4.7 Issuances of debt securities which are listed and proposed to be listed are covered under SEBI (Issue and listing of Debt Securities) Regulations, 2008 ("ILDS Regulations"). The ILDS Regulations mandate to get the debt security rated by a Credit Rating Agency. It also prescribes standardized disclosure formats for an issuer seeking listing of its debt securities provided under Schedule I of the ILDS Regulations. The standard disclosures thus prescribed include disclosures to be made with the stock exchange and with debenture trustees and inter alia include pertinent information relating to the issuer and the issue.

4.4.8 For unlisted debt securities on the other hand, there are no prescribed disclosure norms or standards and hence disclosures associated with any one unlisted debt security may be different from the other. Hence, there is lack of transparency in case of unlisted debt issuances as mostly these are transactions between a limited set of participants and the features of those securities are not known to the broader market. Therefore, investments of mutual fund schemes in unlisted debt securities increases the risk for the investors. Therefore, norms may be prescribed based on the listing status of the debt securities. In such a case, listing of debt securities, automatically ensures that the securities are rated and also results in enhanced disclosure. On the other hand, the fact that a security is rated, does not, on its own ensure its listing status. Thus, directing mutual funds to invest only in listed debt securities shall provide the added benefit of enhanced disclosures.

4.4.9 In terms of the overall impact on Mutual Fund schemes, in case restriction on exposure to unlisted debt securities is prescribed, it is noted that a large number of schemes would not be affected as median value of highest exposure to unlisted debt securities in a quarter as percentage of prevailing scheme AUM is below 15%. The said restriction therefore should not pose an operational challenge at the scheme level. However, considering that only 30-40% of debt securities backed by SOs/CEs are listed (para 4.3.1 above), it would certainly curtail investments in such debt securities and bespoke structures akin to the ones examined.

4.5 Recommendations of MFAC

The above mentioned findings and observations were taken to MFAC for detailed deliberations and their recommendations are as under:

4.5.1 Investment in Listed Debt Securities

Considering the benefits of listed debt securities such as greater transparency, enhanced disclosures and impetus for the development of corporate bond market, MFAC recommended the following:

a) Mutual funds shall be mandated to invest in only listed NCD in a phased manner as given below:

Timeline (As on)	**31/12/2019**	**31/03/2020**	**30/06/2020**	**30/09/2020**
Minimum investment in listed NCDs	85%	90%	95%	100%
Maximum investments in unlisted NCDs (including unrated NCDs)	15%	10%	05%	0%

b) The existing investments in unlisted NCDs may be grandfathered till maturity of those NCDs.

c) All fresh investments in NCDs henceforth, shall only be in listed NCDs for MF schemes whose existing investments in listed NCDs are below the threshold limit as on the timeline proposed above.

d) All fresh investments in Commercial Papers (CPs) shall be made only in listed CPs pursuant to the guidelines by SEBI regarding listing of CPs.

e) Investment into debt instruments such as Interest Rate Swaps (IRS) which are used by MFs to hedge the interest rate risk of the scheme portfolio but are not listed should be exempted from the above provisions.

f) All other existing investment norms shall continue to be applicable.

4.5.2 **Prudential norms for Investment in debt securities having Structured Obligations / Credit Enhancements:**

MFAC noted the concerns pertaining to Mutual fund investments in debt and money market instruments through various structured obligations and complex structures wherein rating of those securities are based purely on external credit enhancement mechanisms. Accordingly, the committee recommended the following in respect of debt securities with credit enhancements:

a) If the rating of debt security with Credit enhancements/ guarantees/ covenants/ arrangements etc. is above investment grade, but is rated below investment grade without such credit enhancements, then, the mutual fund schemes investments in such securities may not exceed 10% of debt portfolio of the respective scheme.

b) The group level limit for investment in such debt securities rated below investment grade but enhanced to investment grade through credit enhancements may be capped at 5% of the debt AUM of the scheme.

c) Overnight and liquid schemes may not be permitted to invest in debt securities having structured obligations (SO) or credit enhancements (CE). However, debt securities backed by government guarantee may be excluded from such restriction.

d) Investment in debt securities having Credit Enhancements backed by equities directly/indirectly may be permitted subject to a minimum 4 times of cover of equities. This may ensure that the investment in debt securities having Credit Enhancements are sufficiently covered to address the market volatility and reduce the inefficiencies of invoking of the pledge/cover, whenever required without affecting the interest of the investors. Further, AMCs should have provisions to ensure protection of the interest of the investors, in case of fall in the value of the cover below the specified limit.

e) However, investments in securitised debt instruments, as defined in SEBI (Public Offer and Listing of Securitised Debt Instruments) Regulations 2008, shall not be subject to the above restrictions.

f) Details of all investments in debt securities having SOs and/or CEs should be disclosed in the monthly and half yearly portfolio statement, distinctively.

g) The existing investments by MF schemes in debt securities having CEs should be grandfathered till maturity of the security.

h) All other existing investment restrictions shall continue to be applicable.

4.5.3 **Credit Evaluation Mechanism at the AMC:**

The existing policy of MFs/ AMCs to conduct an in-house credit risk assessment / due diligence of debt and money market instruments/products may be followed at all points of time i.e. before investing in fixed income products and also on continuous basis in order to have proper assessment of the credit risk of the portfolio. Further, the internal policy should have adequate provisions to generate early warning signals (including yield based alerts) on deterioration of credit profile of the issuer.

4.5.4 **Other recommendations of MFAC**

a) <u>Investment in unlisted equity shares</u> - The MFAC deliberated and suggested that the existing provision that permits Mutual Fund Schemes to invest in unlisted equity shares should be removed and all investments in equity shares shall only be made in listed or to be listed equity shares.

It was noted that as per extant norms, investment norms are applicable at the time of making the investment.

b) <u>Investments by mutual fund schemes in securities of own group companies</u>: MFAC recommended that existing investment norms for investment in debt securities of Group companies may be reduced to 10 % of net assets of the scheme in case of investment in debt securities of its own Group, which may be extended up to 15% with the prior approval of the Board of Trustees.

4.6 **Proposals**

4.6.1 The recommendation of MFAC at paragraph 4.5.1, 4.5.2, 4.5.3 and 4.5.4 (a) above may be accepted.

4.6.2 The recommendation of MFAC detailed at paragraph 4.5.4 (b) above, to review the existing norms regarding investment in own group companies may be considered after examination of relevant data and in consultation with market participants.

4.6.3 The proposals at paragraph 4.5.1 and 4.5.2 may be made applicable w.e.f. January 01, 2020 and the proposal at paragraph 4.5.3 and 4.5.4 (a) may be made effective with in one month from the date of the notification of the above guidelines.

5.0 Valuation of money market and debt securities by Mutual Funds:

5.1 Existing regulatory guidelines and industry practice:

5.1.1 As per MF Regulations, valuation of securities shall be as per the overriding and overarching principles of fair valuation which state that valuation shall be reflective of the realizable value of the securities / assets. The principles also state that the valuation shall be done in good faith and in true and fair manner through appropriate valuation policies and procedures. Further, it is the responsibility of the AMC to ensure fairness of valuation and correct NAV. In addition to the principles, MF regulations and circulars also contain certain prescriptive guidelines on valuation of money market and debt securities which were issued prior to the introduction of the principles of fair valuation in 2012.

5.1.2 As per the existing industry practice, the valuation arm of CRISIL and ICRA (hereinafter referred to as “valuation agencies”) provide security level pricing of debt securities with residual maturity greater than 30 days. Mutual Funds generally take the average of the prices provided by these agencies for valuation.

Money market and debt securities with residual maturity upto 30 days are valued on amortization basis. The amortized price is required to be compared with the reference price, which shall be the average of the security level price of such security as provided by valuation agencies. The amortized price can be used for valuation only if it is within a threshold of ±0.025% of the reference price. In case of deviation beyond this threshold, the price is required to be adjusted to bring it within the threshold of ±0.025% of the reference price.

5.2 **<u>Need for review:</u>**

5.2.1 Proper valuation of securities is important to ensure investor confidence in Mutual Funds (MFs) as a reliable and robust investment vehicle and to ensure that the interests of incoming, outgoing and continuing investors are protected. In a volatile scenario, incorrect valuation may encourage first-mover advantage associated with redeeming at the onset of market volatility, at the cost of the remaining investors.

5.2.2 Thus, considering the critical nature of valuation, the practices of Mutual Funds with respect to valuation were recently reviewed as mentioned at point 3.3.2 above. During this review, the following came to light:

5.2.2.1 As the MF industry and debt market has evolved, certain valuation guidelines, prescribed by SEBI prior to the introduction of the principles of fair valuation in 2012, may not be relevant in today’s market.

5.2.2.2 Further, a consultation paper had been issued by SEBI on uniform methodology for pricing of non-traded and thinly traded non-convertible debt securities which had proposed a detailed framework for valuation of such securities. Upon examination, it was observed that there are few differences in the methodology proposed in the consultation paper and the process followed by the MF industry for valuation of money market and debt securities.

5.2.2.3 In addition, it came to notice that certain valuation practices were being followed by MFs which may be susceptible to mis-use.

5.2.3 In light of the above, a need was felt to streamline & harmonize the existing practices for valuation of money market and debt securities and strengthen the robustness of valuation.

5.3 **Consultative process:**

5.3.1 A proposal was received from the Association of Mutual Funds in India (hereinafter referred to as “AMFI”) for changes required in the SEBI (Mutual Funds) Regulations, 1996 and circulars issued thereunder for removing redundancies and to make these guidelines more reflective of the existing practices on valuation of money market and debt securities.

5.3.2 The aforementioned AMFI proposal and SEBI consultation paper were placed before the Mutual Fund Advisory Committee (hereinafter referred to as “MFAC”) in meeting held on January 24, 2019 for deliberation. MFAC recommended that a working group may be constituted to deliberate on the issues raised in detail.

5.3.3 Subsequently, a working group was constituted under the chairmanship of a member of MFAC and with members from the Mutual Fund industry and valuation agencies.

5.3.4 The working group deliberated on the agenda on “Review of regulatory guidelines on valuation of money market and debt securities” and adopted the following framework for their analysis:

5.3.4.1 Examine AMFI proposal on changes in present guidelines with respect to valuation of money market and debt securities and the need to lay down uniform applicable standards for the MF industry

5.3.4.2 Examine valuation approach mentioned in the SEBI consultation paper and the norms mentioned therein which may be adopted by MFs for valuation of money market and debt securities and

5.3.4.3 Examine any other areas for increasing the robustness of valuation of money market and debt securities by MFs

5.3.5 The report of the working group was presented to MFAC in its meeting held on June 19, 2019. While MFAC broadly agreed with majority of the suggestions of the working group, certain modifications were recommended in few cases.

5.4 **MFAC recommendations:**

The issue-wise recommendations of MFAC are detailed below:

A. On changes in existing regulations / circulars:

5.4.1 **Use of Volume Weighted Average Price / Yield for valuation:**

5.4.1.1 Existing regulatory guideline:

As per existing regulatory guidelines, traded money market and debt securities shall be valued at the weighted average price at which they are traded on the particular valuation day. However, as per the existing industry practice, the last traded yield is being used for valuation.

5.4.1.2 Recommendation of MFAC:

a. Using Yield rather than Price for valuation.

b. Volume Weighted Average Yield (VWAY) for trades done in the last one hour prior to pricing cut-off may be used as the basis for valuation of Government Securities.

c. Valuation of all other money market and debt securities (apart from Government securities), may be done on the basis of VWAY of all trades during the day. In case of any exceptional events on a day, only VWAY of trades post such event may be considered for valuation. At the same time, valuation agencies may check whether the VWAY of all trades in the last 1 hour is materially different than the VWAY of all trades during the day and such cases may be flagged for further review by the agencies.

d. A proposed list of exceptional events may be as follows: Monetary / Credit Policy, Union Budget, Government Borrowing / Auction Days, Material

Statements on Sovereign Rating, Issuer or Sector Specific events which have a material impact on yields and Central Government Election Days. In addition to these events, valuation agencies may determine any other event as an exceptional event and accordingly use post event trades for valuation. Such exceptional events shall be appropriately documented with adequate justification / explanation.

e. All trades reported on trade reporting platforms till end of the trade reporting time, should be considered for valuation on that day. Towards this end, the timing of 9 pm for disclosure of Net Asset Value (NAV) on AMFI / MF website may be suitably extended.

5.4.2 **Valuation of securities with put / call options:**

5.4.2.1 Existing regulatory guideline:

As per existing regulatory guidelines, option embedded securities would be valued as follows:

a. The securities with call option shall be valued at the lower of the value as obtained by valuing the security to final maturity and valuing the security to call option. In case there are multiple call options, the lowest value obtained by valuing to the various call dates and valuing to the maturity date is to be taken as the value of the instrument.

b. The securities with put option shall be valued at the higher of the value as obtained by valuing the security to final maturity and valuing the security to put option. In case there are multiple put options, the highest value obtained by valuing to the various put dates and valuing to the maturity date is to be taken as the value of the instruments.

c. The securities with both put and call option on the same day would be deemed to mature on the put / call day and would be valued accordingly.

5.4.2.2 Recommendation of MFAC:

a. Only securities with put / call options on the same day and having the same put and call option price may be deemed to mature on the put / call date.

b. In all other cases, the cash flow of each put / call may be evaluated and the security may be valued on the following basis:

- Identify a ‘Put Trigger Date’, a date on which ‘price to put option’ is the highest when compared with price on other put options and maturity price.

- Identify a ‘Call Trigger Date’, a date on which ‘price to call option’ is the lowest when compared with price on other call options and maturity price.

- In case no Put Trigger Date or Call Trigger Date (‘Trigger Date”) is available, then valuation would be done to maturity price. In case one Trigger Date is available, then valuation would be done as to the said Trigger Date. In case both Trigger Dates are available, then valuation would be done to the earliest date.

c. Any put / call option inserted subsequent to issue of the bond may not be considered for valuation, since the same may be susceptible to mis-use.

5.4.3 **Updating references to NPAs in the regulations / circulars:**

5.4.3.1 Existing regulatory guideline:

Extant SEBI (MFs) Regulations and circulars refer to the concept of Non-Performing Assets (NPAs) and the related recognition, classification and reporting of the same.

5.4.3.2 Recommendation of MFAC:

a. Considering that unlike the banking industry, an asset is classified as "Default" when there is even a single day delay in payment of principal or coupon, MFAC has recommended that provisions referencing NPAs in the current regulations and circulars be deleted and replaced by a definition of investment grade, below investment grade and default. Further, since there is currently no formal documentation of the definition of investment grade or below investment grade in SEBI Regulations, the standard practice of classifying all assets at BBB-/A3 and above as Investment Grade may be formally recognized and continued.

b. MFAC has also recommended standard treatment of valuation of principal, accrued interest, and future receivable interest for below investment grade and default securities along-with treatment of how any recovery should be accounted for in terms of principal or interest. Details of the same are provided in **Annexure - 1.**

5.4.4 **Other recommendations for changes in existing regulations / circulars:**

5.4.4.1 Recommendation of MFAC:

In addition to the above, MFAC has made recommendations for various other changes in existing regulations / circulars in areas including: valuation of Government securities (including T-bills); methodology for valuation of repo including TREPS (Tri-party repo); definition of non-traded debt securities; valuation of securities with residual maturity upto 30 days; deletion of various provisions including definition of thinly traded debt securities, methodology for valuation -construction of risk free benchmark and building a matrix of spreads for marking-up the benchmark yields, mark-up / mark-down yields, among others. Details of the same are provided in **Annexure - 1.**

B. On framework for valuation of money market and debt securities:

5.4.5 **Waterfall mechanism and other parameters:**

5.4.5.1 Recommendation of MFAC:

MFAC has prescribed a detailed waterfall approach for valuation along-with recommendations on definition of tenure buckets for similar maturity, process for determination of similar issuer, identification of outlier trades and process for construction of spread matrix. Details of the same are mentioned in **Annexure-1**.

Further, MFAC recommended that while in a majority of cases, valuations can be arrived at using the standard rules, however in certain market conditions, valuation agencies may need a certain degree of flexibility to make exceptions to the rules in order to ensure fair pricing of securities. The criteria for such exceptions and the governance framework for the same may be documented in consultation with AMFI and records of such exceptions may be maintained.

5.4.6 **Code of conduct for polling:**

5.4.6.1 Recommendation of MFAC:

a. Considering the importance of polling in valuation of debt securities, MFAC recommended that a code of conduct may be put in place for polling. The code of conduct may place responsibility on valuation agencies on the procedure for polling and on selection of submitters for polling. Further, responsibility may also be placed on poll submitters towards ensuring that polling is not used to inappropriately influence the market price or levels and that polling captures market conditions in a fair manner.

b. Valuation agencies may ensure diversification of poll submitters. Towards this end, the committee recommended that MFs selected by the valuation agencies may have to mandatorily participate in the polling process. Further, the committee also recommended that SEBI may examine the possibility of having a code of conduct and making polling mandatory for merchant bankers and brokers.

C. <u>On role of valuation agencies and AMFI regarding valuation of money market and debt securities:</u>

5.4.7 **Valuation of all money market and debt securities to be provided by valuation agencies:**

5.4.7.1 <u>Recommendation of MFAC:</u>

Considering that valuation of certain debt instruments such as Interest Rate Swaps is currently not provided by the valuation agencies, the committee recommended that valuation of all money market and debt securities may be provided by the valuation agencies as a part of their arrangement with AMFI.

5.4.8 **Implementation of guidelines on valuation of money market and debt securities:**

5.4.8.1 <u>Recommendation of MFAC:</u>

With respect to the implementation of the framework on valuation of money market and debt securities, MFAC recommended that:

a. Considering that operational guidelines for valuation of money market and debt securities form part of both MFs Regulations and circulars, the committee recommended that all existing operational guidelines related to valuation of fixed income securities may be consolidated in circulars and only the Principles of Fair Valuation may form part of the MF Regulations.

b. The regulations / circulars may be updated to recognize the role of the valuation agencies.

c. AMFI, in partnership with the valuation agencies, shall document a harmonized and standard set of valuation guidelines to be followed by both valuation agencies. The same shall be submitted to SEBI and made available in the public domain. Any future changes to these standard valuation guidelines shall be made by AMFI in consultation with SEBI, prior to implementation.

d. Considering that AMCs are responsible of fair valuation, they may deviate from the guidelines for valuation subject to appropriate documentation, disclosures to investors and reporting to Board of Trustees and Board of AMC.

D. <u>Other recommendations for increasing robustness of valuation:</u>

In order to increase the robustness of valuation of money market and debt securities, address potential areas of conflict and possible mis-use, MFAC made the following recommendations:

5.4.9 **Disallowing the use of own trade for valuation:**

5.4.9.1 <u>Background:</u>

Recently, a concern has come to notice on possible manipulation in valuation by MFs through use of their own trades (including where they are on one side of the trade) of relatively small value in order to value the traded security across all their schemes. For instance, a MF scheme holding say a particular security of total face value INR 100 crore would execute an INR 5 crore trade with a counter-party at a high valuation. The remaining INR 95 crore would then be valued at the traded price, thus resulting in a sharp jump in valuation in one day.

5.4.9.2 <u>Recommendation of MFAC:</u>

In order to address possible mis-use as mentioned above, MFAC has recommended that MFs may not be permitted to use own trades for valuation of debt and money market securities.

5.4.10 **Valuation of ISTs:**

5.4.10.1 Existing regulatory guidelines mandate that Inter-scheme transfers (ISTs) shall be done at the prevailing market price for quoted instruments on spot basis.

5.4.10.2 Recommendation of MFAC:

MFAC has recommended that AMCs may be required to seek spot prices for IST from both valuation agencies and the average of the spot prices received may be used for IST pricing.

5.4.11 **Changes in terms of issue of ISIN:**

5.4.11.1 Recommendation of MFAC:

MFAC has made the following recommendations:

a. Any changes to the terms of issue of an ISIN are to be reported to both the valuation agencies.

b. If the maturity date of a debt or money market instrument is shortened, the same cannot be subsequently extended.

c. Any extension in the maturity of a bond shall lead to the bond being treated as “Default”, for the purpose of valuation.

5.4.12 **Payment of Upfront fee by issuer of debt securities:**

5.4.12.1 Recommendation of MFAC:

With respect to the matter of upfront fees / commissions / charges which are at times offered by issuers of debt securities, MFAC deliberated that MFs only make up a part of the bond market and thus, a blanket ban on fees only for MFs may limit the avenues for investment. MFAC thus recommended permitting such fees with disclosure of all such fee to valuation agencies and a standard methodology for valuation which may be issued by AMFI, in consultation with SEBI.

5.4.13 **Guidelines for investment by MFs in partly paid debentures:**

5.4.13.1 Background:

a. Recently, certain NCD structures have come to light wherein the required initial subscription amount is 5% of total issue size with a further demand for additional subscription being raised by the issuer if the investor does not accept the quarterly CP subscription offer of the issuer. In the event that the investor does not accept the CP subscription and also does not honour the demand for additional subscription, then the issuer will have the right to forfeit the initial amount paid up on the debenture.

b. This clause of subscription to CPs every quarter ensures that these funds are available for the long term for the issuer. Further, while the effective interest rate for such CP structures would be higher than plain vanilla CPs, it would be lower than raising funds through NCDs. Thus, the issuer is in effect, able to raise long term debt at comparatively lower interest rates.

c. In case of Mutual Funds, it is observed that a scheme with longer duration makes the initial investment in the NCD while the investment in the CP would be made through the liquid scheme. Since the maturity of the CP would be within 91 days, this enables the Mutual Fund to technically comply with the regulatory requirement that liquid schemes can make investments in debt and money market securities with maturity of upto 91days only, while at the same time offering higher returns in their liquid schemes.

5.4.13.2 Recommendation of MFAC:

Considering that investments in partly paid debentures may be susceptible to misuse as stated above, MFAC recommended that standard guidelines for investment by MFs in partly paid debentures may be issued by AMFI, in consultation with SEBI. These guidelines may specifically state that:

a. There should not be any linkages across schemes while investing in partly paid debentures.

b. All demands for additional subscriptions should be linked to clear, pre-defined events.

5.5 The comparative table on recommendations of the working group, recommendations of MFAC and proposals to the Board is placed at **Annexure - 1.**

5.6 **Proposal:**

5.6.1 The recommendations of MFAC at paragraphs 5.4.1.2, 5.4.2.2, 5.4.3.2, 5.4.4.1, 5.4.5.1, 5.4.6.1, 5.4.7.1, 5.4.8.1, 5.4.9.2, 5.4.10.2, 5.4.11.1, 5.4.12.1 and 5.4.13.2 may be accepted. However with respect to the recommendation at point 5.4.9.2 above, along-with accepting the MFAC recommendation that own trades may not be used by MFs for valuation of debt and money market securities, it is proposed that own trades may also not be used by MFs for pricing of Inter-scheme transfers.

6.0 Proposals for consideration and approval of the Board:

6.1 The Board may consider and approve the proposals at paragraphs 3.5, 4.6 and 5.6 above.

6.2 In case of proposals requiring amendments to SEBI (Mutual Funds) Regulations, 1996, the draft amendments will be placed in the next Board meeting and implementation of certain proposals will be by issuance of circulars. The Board may authorize the Chairman to take steps to implement the proposals with consequential and appropriate changes, as may be required in this regard.

Annexure - 1

This has been excised for reasons of confidentiality.