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The Debt Mutual Fund Dilemma

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The last few weeks were tumultuous for debt mutual fund schemes. Investors have been seeking redemption on account of a mix of cash-flow needs and credit-risk concerns. Unfortunately, liquidity, which was never a strength of the Indian debt market, has taken a turn for the worse, post-Covid. On Thursday (April 23rd), Franklin Templeton Mutual Fund announced immediate winding up of six of its debt schemes, amounting to over Rs25,000crore in net assets. Unit-holders in these schemes will receive moneys as and when investments in the portfolio of these schemes are realized. Two regulatory interventions followed:

- SEBI relaxed the default recognition norms for mutual funds. Valuation agencies do not have to treat payment delays and maturity extensions resulting from Covid-19 as defaults, while valuing money market and debt securities held by mutual funds.

  But for this relaxation, declining Net Asset Values (NAV) would have sparked panic, and contagion would have caused a run on the mutual fund industry. Unit-holders who exited at the illiquidity-driven written-down NAV would feel cheated, if the written-down investments realized better or full value later.

- RBI announced a new Rs50,000 crore facility through banks, for mutual funds. Banks can provide funding to mutual funds as loans and purchase and / or repos of investment grade securities. RBI will re-finance banks at the fixed repo rate.

  This facility ensures that investors who seek redemption receive their money from the mutual fund scheme even when the debt market is illiquid. How many banks pick the bait, remains to be seen.

The portfolio of the six funds of Franklin Templeton that are being wound up, as on March 31, 2020, had a negligible component of non-investment grade securities. With the benefit of hind-sight, many of the deployments in investment-grade securities too can be questioned. Incidentally, some of these schemes have investments in Yes Bank and Vodafone. These were segregated earlier, to be paid to investors as and when moneys are received.

An understanding of open-end schemes is required to get into the root of the debt mutual fund dilemma. Open-end schemes allow any-time entry and exit of unit-holders at the scheme's Net Asset Value (NAV). In the normal course, mutual fund schemes sell investments to generate money to meet the redemption requirements of unit-holders who choose to exit. They are also allowed to borrow upto 20% of net assets for a maximum period of 6 months to meet redemption requirements.

Suppose, an open-end debt mutual fund scheme, which has issued 5crore units holds investments of Rs100crore. For simplicity, let us ignore all other assets and liabilities of the scheme. The NAV of the scheme would be Rs100crore ÷ 5 crore i.e. Rs20 per unit. At 20% of net assets, the scheme can borrow upto Rs20crore. Let us assume that 1 crore units come for redemption. At Rs20 per unit, the scheme needs to arrange Rs20crore to meet redemption requirements. Suppose, the scheme chooses to borrow this amount. It will have 4 crore units outstanding after the redemption of 1 crore units. At NAV of Rs20 per unit, unit-holders will have a claim of 4cr units X Rs20 per unit i.e. Rs80crore from the scheme, which would also owe Rs20crore to the bank. Against this total due of Rs100crore, the scheme holds investments of Rs100crore. So, it is all kosher for now. There is the minor aspect of interest cost on the Rs20crore borrowing; this will be a drag on the NAV in future.

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What happens if the full value of Rs100crore is not realized from the investment portfolio? Suppose, only Rs92crore is realized. The bank will still need to be repaid its Rs20crore (plus interest, which is ignored here for simplicity). What is left is Rs92crore *minus* Rs20crore i.e. Rs72crore for unit holders holding Rs4crore units. The NAV is now Rs72crore ÷ 4crore i.e. Rs18 per unit. The earlier investors have walked away with Rs20 per unit. If the loan had not been taken, and the scheme had done a Franklin Templeton, all investors would have received Rs92crore ÷ 5 crore units i.e. Rs18.40 per unit, without having to bear any interest cost.

Higher the redemptions, more would be the gap between the Rs20 received by unit-holders exiting early, and what is realized by the investors who choose to continue in the scheme. Let us not forget, 56% of the net assets of debt mutual funds in the industry is from institutional investors. The balance 44% includes retail and high net worth individuals. So, the man in the street, who might suffer a knowledge asymmetry, is at the mercy of the more knowledgeable This is the dilemma mutual funds face. Their options are:

- Option 1
  Segregate the investments that are not liquid, as Franklin Templeton had done earlier for investments in Vodafone and Yes Bank. But, what does the scheme do when a significant portion of the portfolio is illiquid? Nothing much may be left in the scheme after the illiquid securities are segregated. It effectively transitions to Option 2.

- Option 2
  Wind-up the scheme as Franklin Templeton has done for these six schemes.

- Option 3
  Borrow upto 20% of net assets. As the net assets keep shrinking, the borrowing limit too will shrink. This is besides the Rs20 versus Rs18 problem mentioned earlier. The fact is that given the uncertainty prevailing in the economy, it is difficult to predict the realizable value of investment portfolios.

Franklin Templeton has perhaps taken a prudent call in the interest of unit-holders. Payment will come in phases as and when investments are realized. But ALL unit-holders as on the effective date of winding-up will at least receive the ENTIRE money that the scheme portfolio yields in future.

The subsequent relaxations by SEBI and RBI have ensured that unit-holders' trust in the mutual fund industry is protected. Mutual fund schemes can fulfil their redemption obligations at valuations that are not affected by illiquidity in the debt market.

The ball is in the court of mutual funds. They should avail of the regulatory relaxations *only if they are absolutely sure that credit risk is not masquerading as liquidity risk.* An injudicious decision will effectively mean kicking the can into the future, and risking their own long-term brand value – apart from destroying the trust and faith of unit-holders that SEBI and RBI are seeking to protect.

Feel free to get in touch at team@mavuca.in to share your experiences or discuss how we can help you.