Mutual Funds and Market Development in India*

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I. Introduction

Financial sector development can be viewed as a process that enhances four critical attributes of the financial system: efficiency, stability, transparency and inclusion. The emergence of intermediation mechanisms and products that help improve on one or more of these without causing others to weaken are, therefore, a meaningful indicator of financial development.

From this perspective, mutual funds play an important role in the development of the financial system. First, they pool the resources of small investors together, increasing their participation in financial markets, which helps both inclusion and the efficient functioning of markets themselves, as a result of larger volumes. Second, mutual funds, being institutional investors, can invest in market analysis generally not available or accessible to individual investors, thereby providing services based on informed decisions to small investors. Decisions made on the basis of deeper understanding of risks and returns contribute to financial stability, besides helping to mitigate market risk for this group of investors. Third, transparency in investment strategies and outcomes, though typically mandated by regulators, is relatively easy to deliver on, so that investors can find out exactly where they stand with regard to their investments at any point of time.

As far as regulation is concerned, mutual funds cut across domains. The Reserve Bank of India regulates three categories of financial markets; money markets, government securities markets and foreign exchange markets. Mutual funds have a presence in the first two and the Reserve Bank is therefore interested in the role that they play in developing them. In what follows, I shall provide a brief description of the role of mutual funds in these two critical markets and discuss some of the regulatory issues that arise. I shall then make some more general comments about the role of mutual funds in financial inclusion.

II. Mutual Funds and Market Development

Mutual Funds have contributed significantly in broadening and deepening of different segments of the Money Market and, to some extent, the government securities market. Money Market Mutual Funds (MMMFs) were introduced in India in April 1991 to provide an additional short-term investment avenue to investors and to bring money market instruments within the reach of individuals.

The guidelines for MMMFs were announced by the Reserve Bank in April 1992. The Reserve Bank had made several modifications in the scheme to make it more flexible and attractive to banks and financial institutions. These guidelines were subsequently incorporated into the revised SEBI regulations. In October 1997, MMMFs were permitted to invest in rated corporate bonds and debentures with a residual maturity of up to one year, within the ceiling existing for Commercial Paper (CPs). The minimum lock-in period was also reduced gradually to 15 days, making the scheme more attractive to investors.

MMMFs have witnessed phenomenal growth over the period. As on May 31, 2011 the total assets under management of the MMMFs were placed at ₹1,83,622 crore[1], 25 per cent of the aggregate assets under management of the Mutual Funds.

In order to promote retail holding in government securities and broaden the investor base, mutual funds, which invest exclusively in government securities, gilt funds, were introduced. The first gilt fund in India

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[1] Source : AMFI Monthly – May 2011

was set up in December 1998. However, gilt funds have registered moderate growth. As on May 31, 2011 the total assets under management of the gilt funds were placed at ₹3,336 crore[2], 0.5 per cent of the aggregate assets under management of the mutual funds.

Mutual funds occupy a large share of the primary market of Certificates of Deposit (CDs) and (CPs). As on June 10, 2011[3] the total holdings of mutual funds in CDs and CPs remained at ₹2,95,164 crore (66 per cent of the aggregate outstanding) and ₹82,951 crore (65 per cent of the aggregate outstanding), respectively. Mutual funds have also provided substantial liquidity to the secondary market segments of CPs and CDs. Their increased activity in the secondary market corresponds to their growing portfolio of money market investments. During the last six months, MFs' share in the daily turnover of the secondary market of CDs and CPs stood at around 41 per cent and 46 per cent, respectively.

The overnight segment of the money market has also benefitted from the participation of mutual funds. Their reliance on the collateralised segment of the overnight markets, *viz.*, market repo and Collateralised Borrowing and Lending Operations (CBLO), for placement of their daily surplus liquidity enhanced the depth of the markets.

By contrast, in the Government securities market, the participation of mutual funds has not been very encouraging. Of the outstanding Government of India dated securities[4], the mutual funds held 0.9 per cent as at end December 2010, which dropped to 0.2 per cent as at end-March 2011. The average holding of government securities by the mutual funds during the last two years remained at 0.6 per cent as against 38.7 per cent by the banks, 22.4 per cent by insurance companies, 8.9 per cent by Primary Dealers (PDs), 6.7 per cent by Provident Fund (PFs), 3.1 per cent by corporate entities. During the current calendar year till end of May, the average share of mutual funds in the secondary G-Sec market remained at 5.8 per cent of the total traded volume. One possible reason for the lower level of participation of mutual funds in the G-Sec market is lack of investor interest in the gilt-oriented mutual funds due to significant interest rate risks.

III. Future Role and Regulatory Issues

There is a need for mutual funds, especially gilt funds, to complement the role of (PDs) in promoting retail holding in government securities. Mutual funds are supposed to tap retail investors, who in turn, to the extent that they have long horizons, provide stability to the market. They also benefit small investors by providing them access to risk-free gilt-edged securities.

The mutual funds are allowed to participate in the Interest Rate Swap (IRS) market for the purpose of hedging their own balance sheet risks. However, their participation has remained quite muted. The IRS market, although very liquid, suffers from a low customer base of around 1 per cent. The mutual funds may increase the use of IRS for hedging their interest rate risk which would help in broadening and deepening of the IRS market.

Mutual funds are also allowed by SEBI to trade on Interest Rate Futures (IRF). IRF contracts on 10-year notional coupon bonds were launched on NSE in August 2009. The product witnessed significant activity during the initial period, but liquidity tapered off subsequently. The Reserve Bank has already issued guidelines for futures contracts on 91-day T-Bills, which are expected to be introduced shortly. The Reserve Bank is also considering introduction of IRF contracts on 2-year and 5-year G-Secs. If the reason for mutual funds not actively participating in the G-Sec market is the underlying interest rate risk, then they obviously should make use of the IRF to hedge their interest rate risk. Their active participation will give impetus to the development of the IRF market.

The launch of Credit Default Swap (CDS) is impending. The guidelines on introduction of plain vanilla OTC single-name CDS for corporate bonds in India would be effective from October 24, 2011. The mutual funds would be eligible to buy credit protection (buy CDS contracts) to hedge their underlying credit risk on corporate bonds. They would also be permitted as market-makers subject to their

[2] Source: AMFI Monthly – May 2011

[3] Source: NSDL

[4] ₹23.3 lakh crore as on December 31, 2010; ₹23.5 lakh crore as on March 31, 2011.

having strong financials and risk management capabilities as prescribed by SEBI and as and when permitted by the SEBI. It is expected that mutual funds' participation will provide momentum to the CDS market.

A significant feature of MMMFs or liquid mutual funds in India is that they have been mainly catering to the short-term investment needs of institutional investors such as corporates and banks whose redemption requirements are large and simultaneous. As on March 31, 2011[5] the investor profile of liquid funds was dominated by corporates (76.5 per cent) followed by Banks/FIs (17.1 per cent), HNIs (5.3 per cent). As a consequence, when the banking sector faces liquidity shortfall and withdraws its investment from liquid mutual funds, they collectively come under stress. This may lead to a sharp fall in banks' fresh investment in liquid funds which, in turn, could intensify the pressure on those entities that receive investments from the liquid funds.

It may be recalled that during October-November 2008, The Rerserve Bank had to provide a special dispensation in the form of Term Repo facility of ₹60,000 crore, under which banks could avail central bank funds to address the liquidity stress faced by Mutual Funds, Non-Banking Financial Companies (NBFCs), and Housing Finance Companies (HFCs). Banks were given an SLR exemption up to 1.5 per cent of NDTL to address this problem.

A related issue is the circularity of funds between the banking system and mutual funds. Banks invest in mutual funds and the mutual funds put large volume of funds back to the banking system through investments in CDs, lending in CBLO and market repos. Such circular flow of funds between banks and mutual funds has the potential for creating systemic instability in times of stress/liquidity crunch. Thus, banks could potentially face a large liquidity risk. In this connection, the Reserve Bank had announced in the monetary policy on May 3, 2011 that the banks' investment in debt-oriented mutual funds to be capped at 10 per cent of networth as on March 31 of the previous year and banks would be given a period of six months to achieve this limit.

[5] Source: AMFI

From a prudential perspective, there is the possibility of banks' investments in the mutual funds getting channelised to sensitive sectors such as real estate and stocks. This may lead to banks' exposure to such sensitive sectors going beyond the prescribed prudential limits.

IV. Mutual Funds and Inclusion

The role of mutual funds in promoting savings continues to be insignificant in India. Despite a long history, assets of mutual funds in India constitute less than 10 per cent of GDP. A cross-country comparison suggests that mutual funds are very popular all over the world. However, assets under them in India are relatively low as compared with other emerging market economies.

One of the major reasons for relatively low activity of mutual funds in India is that penetration, especially in the rural areas, remains small. This is an important issue from the perspective of financial inclusion of low-income households in the formal financial system. It is generally perceived that mutual funds are popular mainly with the middle and high-income groups and have not been found to be an attractive investment avenue for the low-income groups. Thus, if the sector has to grow fast, it needs to devise appropriate schemes to attract the saving of low-income groups, especially in rural areas. This is the only way to ensure participation of all categories of investors in the financial markets, which is crucial for sustained development, both of the financial sector and the economy as a whole.

V. Concluding Remarks

Mutual funds clearly have a significant role to play in financial development. Their *modus operandi* of aggregating pools of saving from a large number of retail investors and deploying these resources in a variety of financial markets, based on different risk-return preferences simultaneously enhances efficiency, stability and inclusion. It is also relatively easy for them to be transparent about both their strategies and outcomes.

This, of course, is a statement of ideal conditions. In the real world, there are clearly barriers to achieving

these objectives. Some of these have to do with penetration, others with the preferences of investors, particularly with respect to duration, some more with legitimate regulatory concerns about systemic risk and yet others with gaps or imbalances in the broader regulatory framework. However, if there is broad agreement that appropriately regulated mutual fund activity can play a large part in financial development in all its dimensions, these barriers can surely be addressed in a collaborative way between the three stakeholders – the investors, the fund managers and the regulators.