Bringing Back Credit Risk Appetite in Debt Mutual Funds

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Synopsis

- The Securities and Exchange Board of India (SEBI) has recently put forward a proposal to introduce a new category of high-risk debt mutual funds. This initiative is designed to appeal to retail investors with a higher risk appetite and a more nuanced understanding of risk.
- The funds within this proposed high-risk category are expected to benefit from relaxations in sectoral and exposure norms, along with the flexibility to employ high-risk investment strategies. These allowances are anticipated to enable these funds to generate relatively higher returns, thereby positioning them competitively in the market.
- Although this proposal is still in its preliminary phase, CareEdge Ratings views it as a positive development for the debt mutual fund sector. Over the last few years, debt mutual funds have been facing headwinds amid credit crisis, Covid-19 led liquidity disruptions, regulatory shifts followed by cycle of rising interest rates and subdued returns.
- Furthermore, the Finance Bill of 2023 introduced amendments to the taxation of debt mutual funds. Under these amendments, mutual fund schemes with no more than 35% of their assets invested in equity shares are now classified for short-term capital gains, effectively removing the indexation benefits previously available.

SEBI's proposal

SEBI has proposed the introduction of a new category of mutual funds classified as high-risk. This proposal, still in its early stages and under discussion with various stakeholders, anticipates that these high-risk mutual funds will be subject to some relaxations in sectoral and exposure norms. They will also be permitted to employ high-risk investment strategies, which will enable them to generate relatively high returns. Designed to appeal to retail investors with a greater risk appetite and a more sophisticated understanding of risk factors, this new category may feature elevated minimum investment thresholds. While the minimum investment in various debt mutual funds currently ranges from Rs. 100 to Rs. 5,000, this threshold is expected to be higher for the proposed category but still lower than that for Portfolio Management Services (PMS) and Alternative Investment Funds (AIFs), which stand at Rs. 50 lakhs and Rs. 1 crore, respectively.

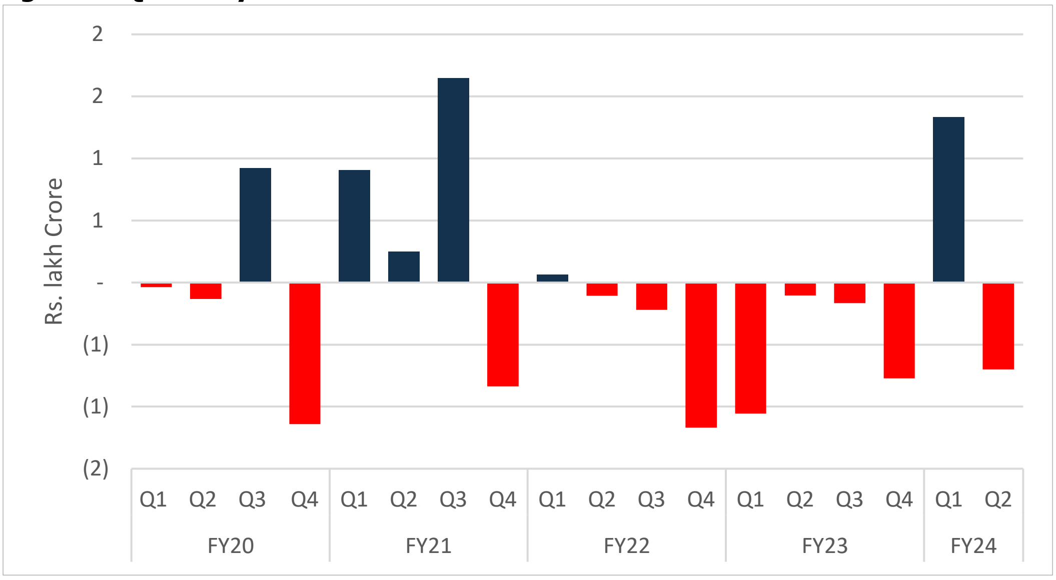
Given the inherent risks associated with this category, SEBI might allow closed or gated fund structures, which would include periodic redemption cycles.

This proposal emerges against the backdrop of Assets Under Management (AUM) in debt mutual funds experiencing stagnation and significant outflows in the last two to three years.

Outflows Continue; Debt MF Share Declines

Debt mutual funds have seen outflows in 12 of the last 18 quarters, spanning from Q1 FY20 to Q2 FY24. During this period, outflows from debt mutual funds amounted to approximately Rs. 1.31 lakh crore. This has led to a consistent decline in the proportion of debt MF AUM as a percentage of the total MF industry AUM, dropping from 53% in March 2020 to 30% in September 2023.

Figure 1: Quarterly Net Inflows & Outflows of Debt Mutual Funds



Source: AMFI, CareEdge Ratings

While some proportion of declining mix can be attributed to rising valuations of equity mutual funds; absolute AUMs of debt mutual funds have been range-bound. The growing popularity of equity funds, rising trend of bond yields (with aggregate increase in policy rate by 250 bps since May 22) as well as muted returns have together contributed to outflows.

Table 1: Tenure wise returns of FDs and Debt mutual funds

	Mar-19		Mar-20		Mar-21		Mar-22		Mar-23		Sep-23	
	FD rate	Debt MF yield	FD rate	Debt MF yield	FD rate	Debt MF yield	FD rate	Debt MF yield	FD rate	Debt MF yield	FD rate	Debt MF yield
1 to 3 year	6.3-7.3	8.2-9.5	5.0-6.2	6.7-8.1	4.9-5.3	4.8-5.6	5.0-5.2	5.1-5.7	5.3-5.6	7.8-8.2	6.0-7.1	7.4-7.9
3 to 5 year	6.3-7.3	7.5-9.1	5.7-6.4	6.6-8.0	5.3-5.5	4.8-5.6	5.1-5.6	4.9-5.8	5.4-5.9	7.6-8.0	6.5-7.0	7.5-7.9
Above 5 year	6.3-7.3	7.3-10.1	5.7-6.4	6.3-8.9	5.3-5.4	4.9-7.0	5.1-5.5	4.7-7.0	5.4-6.1	7.3-8.1	6.0-6.9	7.2-8.0

Source: FD rates of 5 major SCBs as per RBI data, AMC websites
1-3 year YTMs include yields across Short term funds of top 8 AMCs (by AUM)
3-5 year YTMs include yields across Corporate Bond Funds & Banking and PSU debt funds of top 8 AMCs (by AUM)
Above 5-year YTMs include yields across Dynamic Bond Funds of top 8 AMCs (by AUM)

Post March 23, the amendment in taxation of debt mutual funds too has taken away some sheen off debt mutual funds as an asset class. According to new taxation laws, the indexation benefits applicable on LTCG (long term capital gains) on debt mutual funds has been removed. During April- September 2023 period, inflows in debt mutual funds have been primarily towards shorter duration/ liquid funds while AUMs of medium to longer duration funds have been range-bound.

Table 2: FD volume and Open-Ended Debt Mutual Funds AUM:

Particulars/Year	Mar-20	Mar-21	Mar-22	Mar-23
FD Volume (Rs. Crore)*	77,46,845	84,01,091	90,94,708	1,03,18,562
Open Ended Debt MF AUM (Rs. Crore)	10,29,142	13,28,226	12,98,961	11,81,982

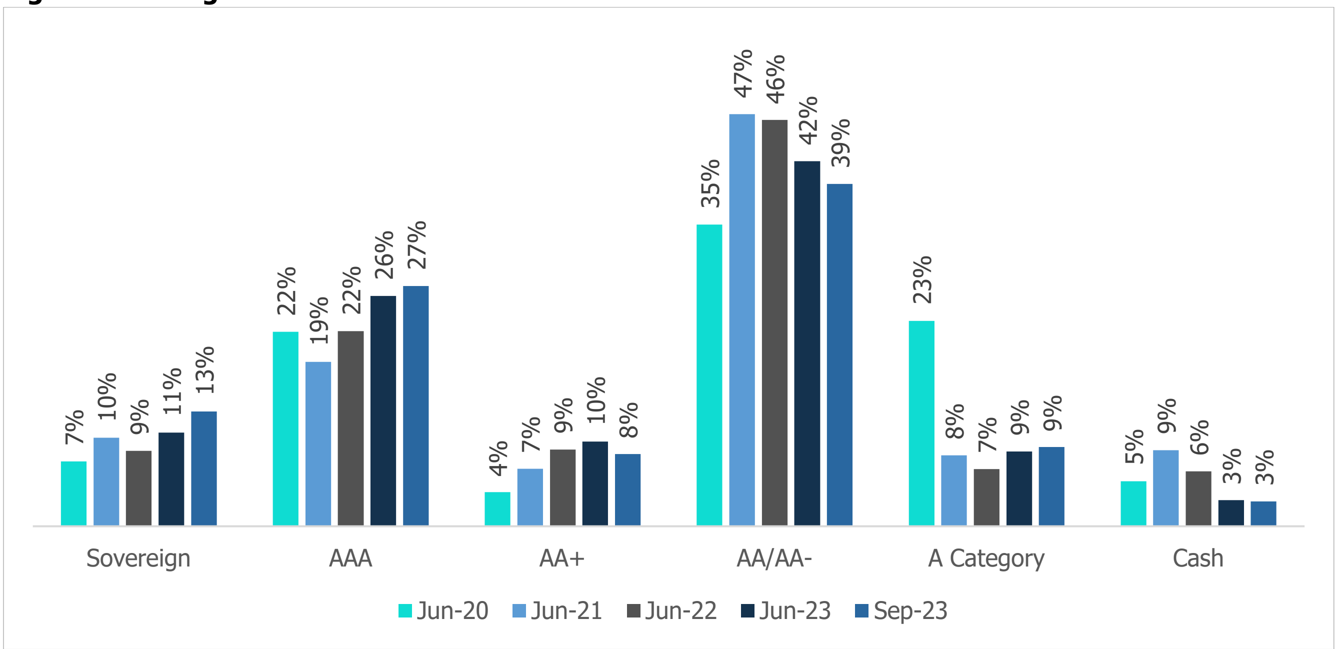
Source: AMFI, RBI
*Term deposits of SCBs

The AUM of open-ended debt mutual funds stood at roughly Rs.13 lakh crore, as compared to outstanding term deposits base of banking sector at Rs.115 lakh crore respectively as on September 30, 2023, thereby showcasing the scope of growth of debt mutual fund industry.

Credit Risk: Risk- Off Sentiment Leads to Higher Mix of Safer Securities

The trend towards prioritising safer and more liquid securities in the mutual fund industry had already begun due to the credit crisis. This shift gained further momentum following the winding up of few debt mutual fund schemes and the implementation of significant regulatory changes. These changes encompassed various aspects, including increased investment in liquid securities, the introduction of sectoral caps, limitations on funds' exposure to riskier or unlisted instruments, revisions in valuation norms, and enhanced disclosure requirements regarding risk, performance, and portfolio details. These regulatory adjustments have played a crucial role in shaping investment strategies and risk management within the debt mutual fund sector.

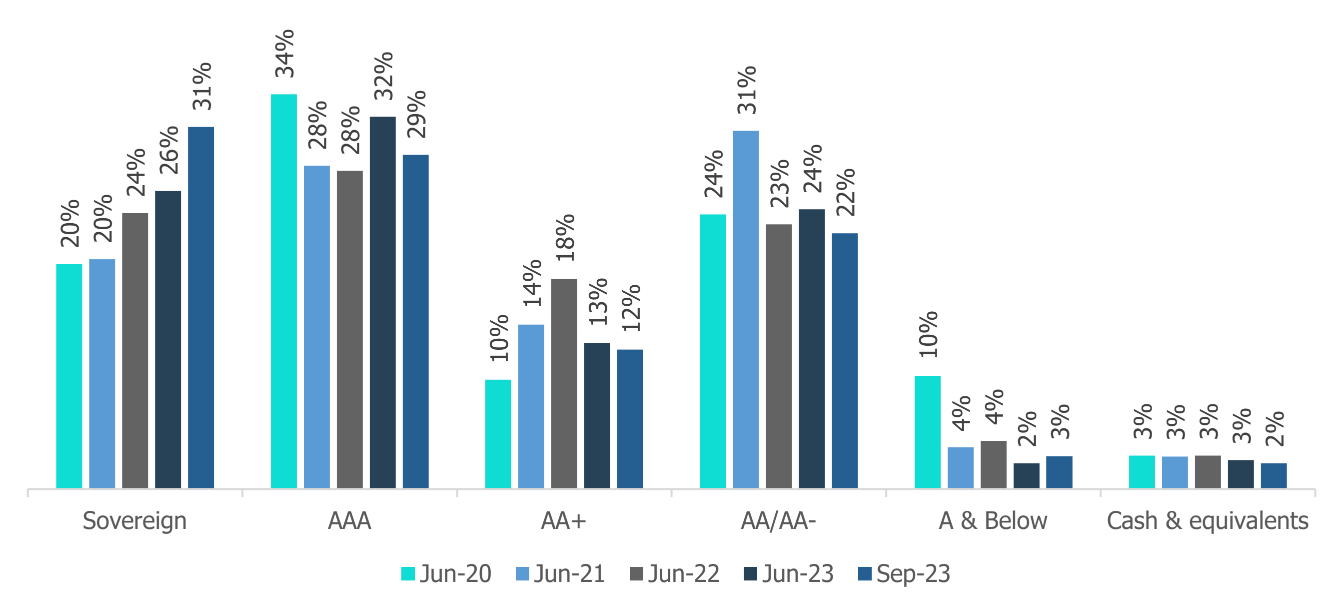
Figure 2: Rating mix- Credit Risk Funds



Source: Care Rating's analysis of credit quality of credit risk funds of top 8 AMCs portfolio, AMC websites

Within the credit risk fund as a cohort, proportion of A rated debt instruments dipped significantly post June 2020 and has continued to remain low.

Figure 3: Rating mix- Medium Duration Funds



Source: CareEdge Ratings analysis of credit quality of medium duration funds of top 8 AMCs portfolio, AMC websites

Within the medium duration funds, there has been visible rise in sovereign investments largely contributed by declining risk- reward tradeoffs in corporate and BFSI securities as well as increased risk aversion.

CareEdge Ratings View

The recent proposal by the SEBI to introduce a new category of high-risk mutual funds is anticipated to be beneficial for the entire mutual fund industry, according to CareEdge Ratings. This perspective is particularly positive for debt mutual funds, which have encountered several challenges in recent years. These challenges include the withdrawal of indexation benefits, credit crises, liquidity disruptions triggered by Covid-19, regulatory changes, and a cycle of rising interest rates.

The removal of indexation benefits has created a more level playing field with other investment products in terms of returns. However, debt mutual funds remain susceptible to interest rate cycles, which can adversely impact returns.

Against this backdrop, SEBI's proposal to establish a new type of high-risk mutual fund category could provide a boost to the industry. This move is especially timely given the range-bound AUMs observed over several quarters and provide a much required fillip for growth.

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