RBI's Liquidity Offer for Mutual Funds

Why in News

Recently, the **Reserve Bank of India (RBI)** announced a **special liquidity window of Rs 50,000 crore** to bail out mutual funds hit by the turmoil in the debt fund segment.

Key Points

- **Repo Operations:** Under the **special liquidity facility for mutual funds (SLF-MF),** the RBI will conduct **repo (repurchase agreement) operations** of 90 days tenor at fixed rate for banks.
    - A repurchase agreement, or 'repo', is a **short-term agreement** to sell securities in order to buy them back at a slightly higher price.
    - The **one selling the repo (banks) is effectively borrowing** and the other party (the RBI) is lending.
- **Providing Liquidity to Mutual Funds**
    - Funds availed under the SLF-MF will be used by banks **exclusively for meeting the liquidity requirements of mutual funds.**
    - Under the SLF-MF, **banks can extend loans to mutual funds** and undertake outright purchase of and repos against the collateral of investment grade corporate bonds, commercial papers (CPs), debentures and certificates of Deposit (CDs) held by mutual funds.

- **Features of the offer**
    - The RBI said liquidity support availed of under the SLF-MF would be eligible to be classified as **Held-To-Maturity (HTM).**
    - The face value of securities acquired under the SLF-MF and kept in the HTM category would not be reckoned for computation of **Adjusted Non-food Bank Credit** (ANBC) for determining priority-sector targets/sub-targets.
    - Support extended to MFs under the SLF-MF shall be exempted from banks' **capital market exposure limits.**
    - Exposure under this facility would not be reckoned under the **Large Exposure Framework (LEF).**
- This is the **third time the RBI is opening the liquidity window** for the financial sector players in the last 15 years.
    - The RBI had opened a special liquidity repo window for mutual funds in 2008 at the time of the global financial crisis.
    - In July 2013 again RBI opened a special liquidity repo window, when returns on debt mutual funds dropped sharply after the rupee fell significantly against dollar.
- **Background**
    - Volatility in capital markets has intensified the stress on mutual funds due to the redemption pressures related to the **closure of six debt schemes of Franklin Templeton** and potential contagious effects.
    - The stress is, however, confined to the high-risk debt funds segment at this stage while the larger industry remains liquid.
- **Outcome**
    - The RBI move on pumping liquidity will boost investor confidence in the mutual fund industry.
    - The RBI's liquidity offer is expected to bring some degree of comfort in the debt market which is under huge redemption (paying back) pressure, especially in the **credit risk fund** category.

Key Terms

- **Mutual Fund:** A mutual fund collects money from investors and invests the money, on their behalf, in securities (debt, equity or both). It charges a small fee for managing the money.
- **Debt funds** aim to generate returns for investors by investing their money in avenues like bonds and other fixed-income securities.
- **Credit-risk funds** are **debt funds** which have **at least 65% of their investments in less than AA-rated (i.e. in lower-rated) papers.**
- **Held-to-maturity** securities are purchased to be owned until maturity. E.g bonds.

- **Adjusted non-food Bank Credit** includes non-food bank credit and total non-**statutory liquidity ratio (SLR)** investments of banks in commercial papers, shares and bonds/debentures.
- **Capital Market exposure** refers to the percentage of a portfolio, invested in a particular type of security, market sector or industry

    It is also known as the exposure amount an investor can lose from the risks unique to a particular investment.
- **Large Exposures Framework:** The large exposures framework **sets prudent limits to large exposures of banks,** which may result in a concentration of its assets to a single counterparty or a group of connected counterparties.
    - To address this concentration risk, RBI has fixed limits on bank exposures.
    - As per current guidelines of RBI, a bank's exposure to a single borrower is restricted to 15% and to a borrower group 40% of capital funds.

Source: IE