

## **Restrictions on investments by Mutual Funds**

### **1. Objective**

The objective of this memorandum is to place a proposal for amendment to SEBI (Mutual Funds) Regulations, 1996 (MF Regulations) and circulars issued there under with respect to restrictions on investments by MFs.

### **2. Background**

2.1. Mutual Fund is a professionally managed investment vehicle where the funds are deployed as per the given investment objectives and strategy of a scheme in a way that provides a prudent spread of risk.

2.2. Retail investors find it easier to achieve diversification through ownership of MFs rather than through ownership of individual stocks or bonds. Further, diversification becomes even more important in case of debt instruments as the liquidity of these securities is lower when compared with that of equity.

2.3. To achieve the aforesaid objective, Seventh Schedule of MF Regulations and circulars dated 13 September 2012, 19 November 2012 and 24 March 2014, place the following investment restrictions on investment in debt instruments:

2.3.1. A MF scheme shall not invest more than 15% (extendable up to 20% with the prior approval of the Trustee and AMC Board) of its NAV in debt instruments issued by a single issuer which are rated not below investment grade by a credit rating agency authorized to carry out such activity under the SEBI Act, 1992. Additionally, no MF scheme shall invest more than 30% of its net assets in money market instruments of an issuer. This limit is not applicable for investments in Government securities, treasury bills and collateralized borrowing and lending obligations.

2.3.2. A MF scheme shall not invest more than 10% of its NAV in unrated debt instruments issued by a single issuer and the total investment in such instruments shall not exceed 25% of the NAV of the scheme. All such

investments shall be made with the prior approval of the Trustee and AMC Board.

2.3.3. MFs/AMCs shall ensure that total exposure of debt schemes of MFs in a particular sector (excluding 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) shall not exceed 30% of the net assets of the scheme. An additional exposure to financial services sector (over and above the limit of 30%) not exceeding 10% of the net assets of the scheme is allowed by way of increase in exposure to Housing Finance Companies (HFCs) only. The additional exposure to such securities issued by HFCs are rated AA and above and these HFCs are registered with National Housing Bank (NHB) and the total investment/ exposure in HFCs shall not exceed 30% of the net assets of the scheme.

### **3. Rationale for Amendments**

3.1. The single issuer investment restrictions were introduced in 1996 while money market instruments restrictions were introduced in 2009. The industry has witnessed manifold increase in AUM since 1996. This has meant that within the extant restrictions, the potential for absolute amount of exposure to a single issuer has increased substantially.

3.2. Such high levels of exposure pose serious concerns in the wake of recent events in debt markets, such as ratings downgrade of bonds, references to corporate debt restructuring/joint lender's forum/etc. This necessitates a review of the exposure limits of MFs at issuer level and sector level. Additionally, there may be a need to introduce exposure limits at group level (which are currently non-existent) so as to provide a sufficient spread of risk through diversification of the investment portfolio.

#### **4. International Practices**

A study of existing regulations and guidelines in other jurisdictions was undertaken. In this regard, the practices followed in certain jurisdictions, such as UK, USA and Singapore, are as follows:

##### **4.1. UK – The 5/10/40 rule**

4.1.1. For Undertakings for Collective Investments in Transferable Securities (UCITS), there are limits in terms of the percentage of the total value of the fund's assets that may be invested in approved transferable securities (i.e. shares, debentures, government and public securities, warrants and certificates representing certain securities) and money market instruments issued by a single entity.

4.1.2. A UCITS cannot invest more than 5% of its assets in transferable securities or money market instruments issued by a single entity. This limit can be increased to 10% per single entity provided that the total value of such holdings over 5% does not exceed 40% of the total value of the fund. This is referred to as the 5/10/40 rule.

4.1.3. The concentration rules require that a UCITS must not acquire more than 10% of the debt securities issued by any single body or 10% of the approved money-market instruments issued by any single body.

##### **4.2. USA - Regulated Investment Companies (RIC) Rule (5/50 rule)**

4.2.1. The U.S. Internal Revenue Code imposes diversification requirements that investment companies in the United States must meet to qualify as RICs for favorable pass-through tax treatment.

4.2.2. The RIC diversification rules require that no more than 25% of a fund's assets can be in the securities of a single issuer or of two or more issuers engaged in the same or similar trades or businesses or related trades or businesses. Furthermore, with respect to 50% of the assets of the fund, no

more than 5% of the securities can be those of a single issuer, which means that at least 50% of the assets of fund should be invested in securities which individually have less than 5% weight in the portfolio. These restrictions do not apply to investment in Government securities.

#### 4.3. Singapore

4.3.1. **Single entity limit:** Investments in transferable securities (i.e., shares or securities equivalent to shares and bonds or other securitized debt instruments) or money market instruments issued by a single entity should not exceed 10% of the scheme's NAV.

4.3.2. **Group limit:** Aggregate investments in, or exposures to, a group of entities through transferable securities, money market instruments, eligible deposits and counterparty risk exposures arising from the use of OTC financial derivatives should not exceed 20% of the scheme's Net Asset Value (NAV). A group of entities refers to an entity, its subsidiaries, fellow subsidiaries and its holding company.

4.3.3. **Unrated and non-investment grade corporate debt securities:** The single entity limit of 10% for bonds is lowered to 5% of the scheme's NAV if the issuer is not rated or is rated below investment grade.

#### 5. Recommendations of Mutual Funds Advisory Committee

The Mutual Funds Advisory Committee (MFAC) in its meeting held on 29th October, 2015 deliberated upon the proposal to review exposure limits at single issuer, group and sector level. It was agreed that adequate portfolio diversification is a necessary element in Mutual Funds. Thus, there is a need to review the prudential limits at issuer and sector level and need to introduce group level exposure. In view of the above, MFAC recommended that AMFI may deliberate upon the issue of prudential limits and provide recommendations to SEBI based on the need for alignment of diversification, liquidity and product design without linking prudential limits with credit rating of securities.

## 6. Recommendations of AMFI

AMFI members deliberated the above in its Valuation Committee meeting. The committee inter-alia recommended the following:

### 6.1. Rationalization of Single issuer limit

6.1.1. Merge credit exposure limits of money market instruments and non-money market instruments at the scheme-level.

6.1.2. Link Limits with most conservative Long Term credit rating of the issuer as follows:

Most Conservative Rating	Single Exposure Limits as % of scheme AUM	Additional Exposure with approval of Trustees
AAA	15%	5%
AA+	10%	5%
AA	10%	5%
AA-	7.5%	2.5%
A+	5%	2.5%
A	5%	2.5%
A-	5%	2.5%
Below A-	5%	2.5%

6.2. **Sector limits** - The existing regulatory sector limit cap should be kept unchanged.

### 6.3. Group-Level Exposure Limits

6.3.1. Maximum single group exposure at scheme level: 20% of AUM of the scheme

6.3.2. Additional headroom with Trustees' approval: 10% of AUM of the scheme

6.3.3. All Government owned PSU entities, PFI & PSU banks to be excluded from group-level exposure limits.

6.3.4. All group-level exposure limits to be applicable at the time of investment.

6.3.5. All group-level exposure limits to be from prospective basis from the date of implementation.

6.3.6. The proposal to engage an independent 3rd party to classify group-level exposures and its computation could be considered at a later stage.

## **7. Proposals**

The Financial Stability Board's Principles for Reducing Reliance on CRA Ratings (October 2010) have been framed to reduce the financial stability-threatening herding and cliff effects that arise from CRA rating thresholds being hard-wired into laws, regulations and market practices. The principles aim to catalyse a significant change in existing practices to end mechanistic reliance by market participants and establish stronger internal credit risk assessment practices instead. MFAC, in its meeting held on 29 October 2015, also agreed that it is imperative that MFs/AMCs should be able to carry out their own credit assessment of the assets and reduce reliance on credit rating agencies and the credit exposure limits should not be linked with credit rating.

In view of the above, the following is proposed:

7.1. Regulations may be amended to merge credit exposure limits of money market instruments and non-money market instruments at the scheme-level. Further, without linking single issuer limits to any specific credit rating, Regulations may be amended so that single issuer limit that is currently at 15% of NAV (extendable to 20% of NAV after trustee approval) is reduced to 10% of NAV (extendable to 12% of NAV after trustee approval).

7.2. In partial modification of circulars pertaining to sector exposure limits, the exposure limit to a single sector may be reduced from the current 30% of NAV to 25% of NAV. In this regard, the additional exposure limit provided for HFCs in finance sector may be reduced from 10% of NAV to 5% of NAV.

7.3. In line with the sector limits, appropriate circular may be issued to introduce group level limits for debt schemes and the ceiling may be fixed at 20% of NAV (extendable to 25% of NAV after trustee approval). A group, for this purpose, refers to group as defined under section 2 (mm) of SEBI (Mutual Funds) Regulations, 1996 and includes an entity, its subsidiaries, fellow subsidiaries, its holding company and its associates. All Government owned PSU entities, PFI & PSU banks will be excluded from group level limits.

7.4. In addition, the Trustees may be required to review exposure of a Mutual Fund, across all its schemes, towards individual issuers, group companies and sectors. Trustee may satisfy themselves on the levels of exposure and confirmation on the same may be provided to SEBI in the half-yearly trustee report.

#### 7.5. Applicability

7.5.1. The aforesaid investment restriction shall be applicable to all fresh investments by a new scheme or an existing scheme. The restriction shall not be applicable to existing close-ended schemes.

7.5.2. Appropriate time may be given, in case of existing open-ended schemes' investments, for AMC to confirm that such mutual fund schemes conform to the aforesaid investment restrictions.

### **8. Cost-benefit Analysis**

Review of single issuer, sector level exposure limit and introduction of group level exposure limits for investment in debt instruments is likely to mitigate risks arising on account of high levels of exposure in the wake of events pertaining to credit downgrades. Not only does it put Mutual Funds in a better position to handle adverse credit events but also provides mutual fund investors with enhanced diversification benefits.

9. The Board may consider and approve the proposals at para 7 and authorize the Chairman to take steps to implement the proposal by amending the SEBI (Mutual Funds) Regulations, 1996 and circulars, wherever necessary, with consequential

and appropriate changes, as may be required, and to notify the necessary regulations and issue guidelines and circulars in this regard.