

Crisis in short-term debt Mutual Fund could trigger a Flight to Safety...

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The fire sparked off in the backyard of US due to the current financial debacle has singe the economy and all the developed money is now rushing back home at a speed of sound creating a serious liquidity crisis in India. Suddenly the word 'R' recession got the flavor in US and is being compared with the Great Depression of 1929-30.

Back home, the borrowing rates in India have skyrocketed and corporate are forced to borrow at exorbitant rates, even as high as 20-30 per cent. Even with the ease of liquidity due to flow of money in the system by CRR cut has failed to boost the confidence among the investors. The market saw a new low breaching the psychological level of 10,000 completing a full circle for the investors who entered in early 2006.

The mutual fund houses cried foul over the recent spurt in the redemptions by the corporate. The corporate which dominate the MF industry are desperately redeeming out the money probably due to credit crunch in the system. Liquid and Liquid Plus schemes which hold the corporate money in majority due to tax relief given in 1999 to companies parking their short-term surplus assets in MFs bore the brunt of liquidity crisis. A major exposure in realty sector has also put a question on the credibility of the scheme performance. Though until now none of the papers have defaulted but even a single large default could dent the credibility of the mutual fund industry as a whole. Fixed Maturity Plans (FMPs), still the hot cake among corporate and HNIs would be the worst affected in the current predicament albeit there are few takers now for it.

Due to unremitting redemption, the NAVs of some of the short-term schemes have shown negative returns as the portfolios they are holding are becoming difficult to sell in the market since there are no takers and even those who have money seems to have decided to keep it under the pillow. Albeit the RBI introduced a special window of

Rs 20,000 crore repo facility for a period of 14 days to help these funds bridge the gap between the redemption requests and the actual sale of the underlying assets, the borrowing from the repo markets would increase MF's liability and make NAVs decline more. The NAV of a liquid fund is made up only of the acquisition price and accrued interest income. There is no capital gain or loss in the portfolio. The loss in NAV comes when there is a distress sale of a liquid asset.

With the ease of liquidity in the system by RBI with a CRR cut of 2.5% pumping in Rs 1,00,000 crore and with another cut of 1.5% in SLR (albeit

temporary) provided some reprieve to short-term debt mutual funds but if the crisis continues, a sense of distress can't be ruled out creating an imbalance in the system.

The worst affected would be retail investors who have recently started putting faith in Indian Mutual Fund model. Even the SEBI bawled, "Mutual Funds are meant only for retail investors and not for corporate." The recent large scale redemptions by thwarted corporate clients of mutual funds (MFs), the maker of Mutual Fund industry in India would definitely hurt the retail investors.

In a nut shell, the present crisis in short-term debt mutual funds could trigger a flight to safety for a long time to come.
