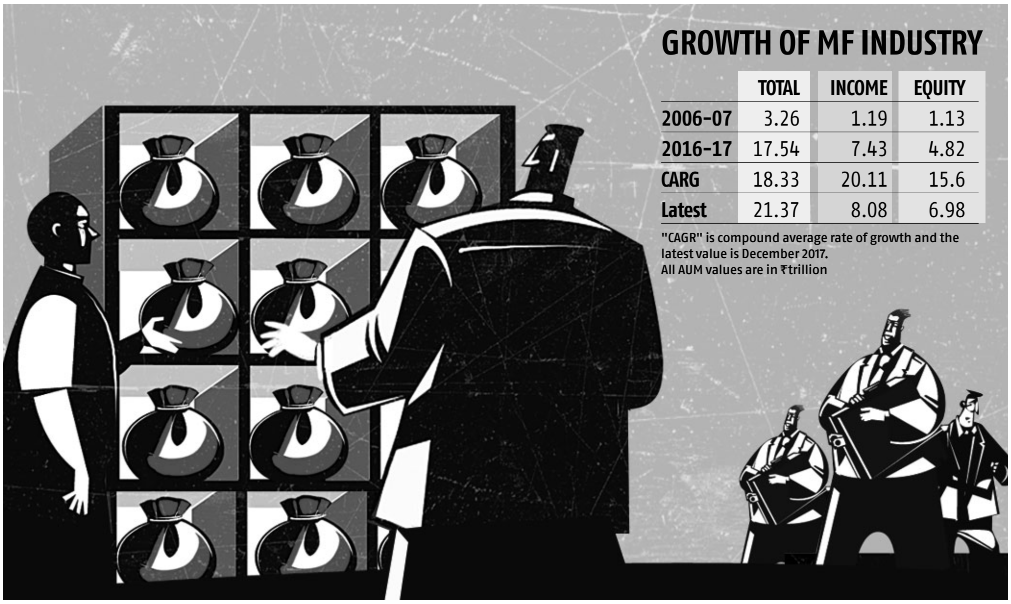
ILLUSTRATION BY AJAY MOHANTY



GROWTH OF MF INDUSTRY

	TOTAL	INCOME	EQUITY
2006-07	3.26	1.19	1.13
2016-17	17.54	7.43	4.82
CARG	18.33	20.11	15.6
Latest	21.37	8.08	6.98

"CAGR" is compound average rate of growth and the latest value is December 2017.
All AUM values are in ₹trillion

Mutual funds with feet of clay

The magic of mutual funds lies in their having transparent and liquid assets. However, this edifice stands on top of secondary market trading

In the last decade, the mutual fund industry has grown remarkably. However, we remain stuck with a fledgling bond market. With a large base of assets, ordinary fluctuations can lead to a day of large sales by mutual funds, which will kick off a large drop in bond prices, which can trigger off more redemptions, and so on. We do wrong by building a large superstructure of a mutual fund industry on feet of clay. This calls for short-term actions — changing the nature of the liquidity promised by mutual funds — and building the Bond-Currency-Derivatives Nexus.

The growth of the mutual fund industry has been simply remarkable. In the 10 years from 2006-07 to 2016-17, assets under management (AUMs) jumped from ₹3.26 trillion to ₹17.55 trillion: An average compound growth rate of 18.33 per cent. Growth has been particularly strong with income funds (20.11 per cent).

Mutual funds are a great concept, and we should be delighted at the rise of one more pillar of financial intermediation in India. However, we should be aware that this edifice stands on top of secondary market trading.

Every day, at random, some customers of mutual funds choose to put in money or take out money. These requests make demands on financial market liquidity. As long as the demand for liquidity by mutual funds is small, compared with the size and capability of the underlying financial market, things work out fine.

When the underlying financial market is inadequate, however, there is a problem. Suppose, through a pure accident or through a news event, a bunch of customers choose to pull out their money on the same day. Suppose this gives a large net withdrawal from the overall mutual fund industry. In an illiquid market, the impact of this large net order placed by mutual funds upon the financial markets is large. Prices will go down and NAVs will go down. This can trigger panic and further exits by other customers. This can turn into a big mess.

SNAKES & LADDERS

AJAY SHAH

This is not a hypothetical scenario. It happened in late 2008, and it was handled through messy methods. The methods that were used to cope with this in 2008 are infeasible today, as various aspects of the situation are now different.

This is not a threat for equity mutual funds, as we have a well-developed equity market ecosystem. We have exchanges, free entry into exchange membership, electronic trading, derivatives trading, algorithmic trading, etc. We have many problems of public policy on the equity markets, but despite the mistakes, the Indian equity market is a sound platform on which the Indian equity mutual fund industry has been built.

An unscientific thumb rule that I apply asserts that it is safe to have equity mutual fund AUM which is smaller than two days of total equity turnover. Right now in India, the spot+derivatives turnover on the equity market is roughly ₹3 trillion a day, and the equity AUM is around ₹7 trillion, so the equity AUM is slightly out of line.

Applying this thumb rule, we have a problem with the bond market. Income funds have an AUM of ₹8 trillion and the underlying bond market has a daily turnover of ₹0.3 trillion. This creates concern about a day of news, or a day of pure bad luck, where there are large redemptions on income funds. These could kick off a panic and a systemic crisis.

At a conceptual level, banks have opaque and illiquid assets. The magic of mutual funds lies in their having transparent and liquid assets. This works on the equity assets where the market delivers prices and liquidity. But given the failure of the Indian bond market, income funds have illiquid though transparent assets.

What is to be done? Artificial restrictions on the growth of the mutual fund industry should be rejected out of hand. Banking-style tricks of hiding bad news, by manipulating the NAV computation, will give us banking-style crises. This mistake, of not doing a correct NAV computation, was made in US-64 and should not be repeated. We should always force NAV computations to face the full rigour of market prices, no matter how unpleasant the bad news is.

This leaves two lines of attack. The first line of attack is to restrict the liquidity of customers of income funds. It is wrong to offer the promise of liquidity to customers when the underlying technology of secondary market liquidity is weak. Mutual funds should see self-interest in designing barriers to liquidity. As an example, in the international experience, hedge funds that invest in illiquid assets routinely have "gates" where exit by customers is limited. The Securities and Exchange Board of India (Sebi) should be examining the extent to which mutual funds today can realistically achieve the promise that they are giving their customers, of unrestricted liquidity.

On their part, policymakers need to do more on building the soft infrastructure of the Bond-Currency-Derivatives Nexus (BCD Nexus). Going beyond mutual funds, all roads lead to the BCD Nexus. We need this from so many points of view, including efficient borrowing for the government, building infrastructure, coping with the banking crisis, achieving capabilities in inflation targeting, safe foreign borrowing by firms, etc.

How can this be done? The full financial markets ecosystem has to come about. For an analogy, the equity market worked because all elements of it were put into play, including Sebi, electronic trading, free entry into exchange membership, cash-settled derivatives, algorithmic trading, index and individual security derivatives, freedom to express positive or negative views, continuous disclosure, millions of trading terminals nationwide, derivatives arbitrage, foreign participation, ETFs, lending against shares, etc. It took a decade of policy battles and institution building, 1992-2002, to get up to today's happy outcome of ₹3 trillion of turnover every day. This institutional infrastructure (SEBI, NSE, BSE, NSDL, CDSL, MCX, NCDEX and their member firms) can be readily applied to deliver the BCD Nexus.

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