Wiggle space

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SEBI's new rules to protect those investing in liquid mutual funds are not tight enough

- According to new regulations issued by the Securities and Exchange Board of India (SEBI), liquid mutual funds holding debt securities with a maturity term of more than 30 days will have to value these securities on a mark-to-market basis.
- Until now, liquid mutual funds could report the value of debt instruments with a maturity term of up to 60 days using the amortisation-based valuation method.
- Only debt securities with a maturity term of over 60 days were to be valued on a mark-to-market basis.
- So the new rule seemingly narrows the scope for amortisation-based valuation.
- Amortisation-based valuation, which is completely detached from the market price of the securities being valued, allowed mutual funds to avoid the volatility associated with mark-to-market valuation.
- SEBI's new rules come in the midst of the crisis in Infrastructure Leasing and Financial Services (IL&FS) that led to various fund managers reporting the value of the same debt instruments issued by the infrastructure lender at vastly different levels.
- The chief financial markets regulator believes that mandating mutual funds to report the value of a greater share of their holdings on a mark-to-market basis can lead to a better and more objective valuation of these securities.
- By exempting securities with a maturity period of up to 30 days from mark-to-market valuation, however, SEBI may be doing no favour to individual investors.
- The latest SEBI rules are also in direct contrast to the usual accounting practices when it comes to the valuation of securities.
- Generally accepted accounting principles mandate securities with the least maturity to be reported on a mark-to-market basis while allowing

the amortisation-based method to be employed to value other securities with longer maturity periods.

- This makes sense as the profits and losses associated with securities with shorter terms are closer to being realised by investors when compared to longer-term securities.
- SEBI would do well to mandate that all investments made by liquid mutual funds should be valued on a mark-to-market basis.
- Simultaneously, it should work on deepening liquidity in the bond market so that bond market prices can serve as a ready reference to ascertain the value of various debt securities.

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