RBI Permits Banks to Invest in Debt Instruments Through Mutual Funds

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In its statement on Developmental and Regulatory Policies, the Reserve Bank of India reduced the risk capital that banks need to set aside against investment in debt mutual funds and exchange-traded funds (ETFs), a move that may improve liquidity in these funds.

Investment in Debt Instruments Through Mutual Funds

Currently, banks have to set aside more capital when they invest in debt mutual funds compared to when they buy debt instruments directly. This is because **investment in debt mutual funds is treated on par with equity funds when it comes to capital requirements of banks.** On the other hand, when banks directly invest in debt papers, capital requirements are generally lower and based on the credit rating and nature of the debt instruments. RBI felt that there was a need to harmonize the two methods of debt investment.

However, noting the risk of sudden redemption in debt funds, the central bank did not go for a complete harmonization. **A general market risk charge of 9% will continue to be applied.** Experts say it’s a positive development from the point of view of debt fund investors. Banks normally park their surplus liquidity in certain debt fund categories like liquid funds. This move will marginally improve flows in liquid funds and possibly corporate bond funds.

Debt Mutual Funds

The debt market consists of various instruments which facilitate the **buying and selling of loans in exchange for**

interest. Debt funds invest in securities which generate fixed income like treasury bills, corporate bonds, commercial papers, government securities, and many other money market instruments. All these instruments have a pre-decided maturity date and interest rate that the buyer can earn on maturity – hence the name fixed-income securities. **The returns are usually not affected by fluctuations in the market.** Therefore, debt securities are considered to be low-risk investment options.