



Cover Page



THE FRANKLIN TEMPLETON DEBT MUTUAL FUNDS CRISIS

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Abstract

The COVID-19-triggered lockdown in India caused a crisis in the capital markets during March and April 2020. A global-wide panic crashed the equity and debt markets as investors feared company operations would be severely affected. The distress has hurt investors who proceeded to stop their ongoing investments and began to redeem funds. The sudden outflows from the mutual fund industry dried up liquidity in the Indian secondary bond market, creating panic in the credit risk segment. Left with no options, Franklin Templeton India (FTI) Mutual Fund had to wind up six of its debt funds, causing industry-wide panic. This event-based study focuses on the series of events that led to the inevitable decision taken by the fund house and the reaction from various stakeholders such as investors and the regulator. Historical Analysis form of the Qualitative Research process is used to analyze the series of events, make observations of the reactions of stakeholders, and draw some lessons out of it. Findings from this study can help us highlight the risks involved in the debt segment and thereby improve our understanding of the crisis management mechanisms of the mutual fund industry.

Keywords: Mutual Fund Crisis, Mutual Fund Regulations, Mutual Fund Liquidity, Liquidity Crisis, Credit Risk Funds.

JEL Classification: G11, G14, G23, G18.

INTRODUCTION

Increased fund flows into Indian mutual funds are making Domestic Institutional Investors (DII) an important feeder of funds to both the capital and debt market of the Indian economy. While FII ownership has been gradually coming down for the period 2015 to 2020, the DII holdings were increasing steadily. Further, the FII-DII ownership ratio has declined sharply for the said period.

Debt mutual funds (also called bond mutual funds) are often perceived to be as safe as a bank fixed deposit by investors. They invest their hard-earned money for the short term, including emerging funds in various debt funds. Despite debacles in the Indian debt market, investor confidence is not that shaken. However, the sudden decision of Franklin Templeton India Mutual Fund to wind up six of its debt schemes has shocked the market and the investor community. At the heart of this issue is the drying up of liquidity in the secondary debt market which was caused by the COVID-19 outbreak and the lockdown declared in the country. Studying the events that lead to the debt market crisis and post-crisis management helps us get insights. Since the lockdown is still ongoing in India, this chapter focus on the events that got unfolded at Franklin Templeton India till the time of this writing.

RREVIEW OF LITERATURE

A study spanning a decade (from 2001 to 2012) showed that there was an increase in interest for debt mutual funds over their equity counterparts.[6] Literature also discussed how debt markets have malfunctioned in the crisis in general, such as during 2007-08 [3] and in specific cases such as in the Indian NBFC crisis triggered by IL&FS that got propagated to debt mutual funds. [1] However, investor interest and attention are always behind returns and top performers within the category. Ultra-short-term funds, for example, were seen as a strong alternative to bank fixed deposits. [7]

RESEARCH METHODS

Objectives of the Study

1. To study the series of events that lead to the crisis in the six debt funds of Franklin Templeton Mutual Fund
2. To investigate the legal issues involved in the closure of the funds



Cover Page



3. To study regulatory steps taken up by SEBI and RBI during the crisis
- 4.

Research Methodology

This paper attempts to understand the various reasons behind the closure of six important schemes of Franklin Templeton. An attempt was made by the researcher to investigate various aspects of the problem. These include studying the operations of Franklin Templeton, reasons for deciding to close schemes, legal issues involved, regulatory role in investor protection, and the procedure they would be following in order to return the money parked by the investors.

The Qualitative Research Method in the form of Historical Analysis is used. The overall plan is to study past events, interpret the facts, and explain the cause of events and relate them to the current events.

Data Collection

The analysis in this paper is based purely on secondary data sources. The data was collected from the articles published online and business media and from the disclosures and press releases by the company.

DISCUSSION

Triggers leading to debt market crisis

The Impact of COVID-19 will have long-lasting negative implications. It is not only creating disruptions in our lives but also on the economy. There has been a dramatic and sustained fall in liquidity in certain segments of the corporate bond market on account of the Covid-19 crisis, and Franklin Templeton Mutual Fund fell victim to it. Its ninth-largest Mutual fund in the country who announced to wind up six yield-oriented managed credit funds with effect from April 23, 2020. All these schemes had combined assets of up to Rs.30,854 crores, which amounted up to 25% of the total assets under management of Franklin Templeton Mutual fund in India. These schemes have a combined AUM of around Rs. 27,000 crores, comprise 63% of AUM of their fixed income portfolio, and effects three lakh investors.

Investors' confidence towards credit risk funds was never high but, coupled with the uncertainty spawned by the lockdown as to the full resumption of the economy, that weak conviction dwindled further. Investors started redeeming in force, FTI had to liquidate their holdings, and eventually, the scheme was left with illiquid, low-rated, and thinly-traded papers.

About Franklin Templeton Mutual Fund

Franklin Templeton India (FTI) started its operations in India in 1996. The Templeton India Growth Fund launched in September 1996 is its first scheme. Its parent - Franklin Templeton Investments - was established in 1947 and had operations in 25 countries and has 600 professionals. FTI took over the operations of the Pioneer ITI Mutual Fund in 2002.

Need for winding up of schemes

On April 23, 2020, the AMC announced winding up of six of its funds owing to redemption pressure and illiquidity in the secondary debt market for low-quality paper. This announcement is the largest windup operation in the Indian mutual fund industry and triggered shockwaves in the domestic credit market. Table 1 shows the names of the schemes and the basic details of the schemes. As can be seen from the table, the schemes have pretty decent long-standing.



Cover Page



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Table 1: The Six debt funds and their categorization

Scheme Name	SEBI Category	MF	Scheme Inception Date	Benchmark Index
Franklin India Ultra Short Bond Fund (FIUBF)	Ultra Short Duration Fund		December 18, 2007	NIFTY Ultra Short Duration Debt Index
Franklin India Low Duration Fund (FILDF)	Low Duration Fund		Monthly & Qtly Div: February 2, 2000 Growth: July 26, 2010	NIFTY Low Duration Debt Index
Franklin India Short Term Income Plan (FISTIP)	Short Duration Fund		Retail Plan: January 31, 2002 Inst. Plan: September 6, 2005	Crisil Short Term Bond Fund Index
Franklin India Income Opportunities Fund (FIIOF)	Medium Duration Fund		December 11, 2009	NIFTY Medium Duration Debt Index
Franklin India Credit Risk Fund (FICRF)	Credit Risk Fund		December 7, 2011	NIFTY Credit Risk Bond Index
Franklin India Dynamic Accrual Fund (FIDA)	Dynamic Bond		March 5, 1997	Crisil Composite Bond Fund Index

Source: Franklin Templeton Monthly Factsheet as of May 29, 2020

In an interview with CNBC TV18, President Sanjay Sapre said that according to the fund house, the COVID-19 lockdown is not a short-term issue, and the outbreak led to heightened redemptions. As Table 2 shows, the AMC saw unprecedented redemption in schemes post COVID-19 and lockdown and started to face liquidity challenges only post mid-March. There was significantly reduced liquidity in the bond market in March-April. The lockdown removed risk appetite from the market and limited liquidity to a small number of issuers. The AMC was not able to fund redemptions from underlying cash flows in the schemes.

The issue might not be unique for FTI, but it seems other AMCs were able to shift some of the illiquid portions of their investments to other schemes, thereby averting a potential problem in their credit risk scheme. The inter-scheme transfers, however, is a potential area that requires further study.



Cover Page



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Table 2: Redemption pressure has put pressure on the scheme corpus

Scheme Name	AUM (Rs. Cr.) August 31, 2018	AUM (Rs. Cr.) March 31, 2020	AUM (Rs. Cr.) April 20 2020
FILDF	6497	2737	2450
FIDA	3566	3119	2709
FICRF	7148	4434	3758
FISTIP	11338	7093	5954
FIUBF	15336	10,964	9979
FIIOF	3783	2506	1930

Source: Franklin Templeton

The funds have managed liquidity with the same philosophy in the past. They followed the core philosophy of generating yield via investing in papers from AAA to A. Individual security selection was based on an assessment of credit attractiveness. If a bond met the requirement of more than one scheme, it was taken in more than one scheme. Each fund followed regulations in portfolio creation & duration. The decision to wind up six funds was an extremely difficult situation for the fund house. There was no restructuring, change in investment philosophy in Ultra Short Bond Fund. A small percentage of papers in the Ultra-short bond fund may have a longer maturity.

All options to salvage funds were under discussion for a long time. He said the regulations only allow suspending redemptions for ten days every 90 days. Creating daily liquidity at any cost was penalizing investors remaining in the schemes. Had considered distress sale of assets, but risk appetite in the market is limited. The fund house did not feel it appropriate to destruct portfolio value to pay redeeming investors. They could not liquidate large portions of the portfolio even at distress prices.

Given the size of funds and balance sheet, it was not possible to furnish liquidity. Given the franchise size, it was not possible for the parent to provide liquidity support. Considered elongating redemption payments to T+10, but it is a short-term measure. The fund house sought and used increased borrowing limits from SEBI in some funds. It did not feel it was prudent to continue borrowing for long periods of time. Further, the line of credit, even at a low cost, is still borrowing and is a liability for the scheme.

The eventual decision was to be made by the Board & Trustees. Winding up of funds does not mean a write-off for investors. Investors in the six schemes will receive their money over a period of time. The AMC does not have full clarity of when and how the environment will return to normalcy.

FTI said it remained committed to investors and its business in India. It said more than 1/3rd of the global workforce is based in India. The AMC has not wound up the Fund of Funds scheme and that the rumors are incorrect. All other funds remain open for subscription & redemption. FTI said it kept the regulator briefed throughout the process and that SEBI understood the situation that the MF is in.

Reacting to the FTI episode, the Association of National Exchanges Members of India (ANMI) has sought the appointment of a high-power committee to take over the management of FT MF. It asked for an examination of the investment decisions of FR MF. It asked for the further safeguard erosion of investor wealth and recover investor investments in a time-bound manner. Though FT says all the investments in the various schemes are made as per the mandates, AMFI hinted that FT might have run credit risk strategy in its income-oriented schemes. Its exposure to certain business groups and a sizable portion of the debt fund assets to unlisted papers is questionable. In an email to investors seeking their nod to liquidate the six schemes, FT said that it might take up to 5 years to return some funds.



Cover Page



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CRISIL, in its report on debt funds, said that Rs. 3,000 crores of the side pocketed funds that got locked up in the six FT schemes would be difficult to get recovered any time soon owing to the halt in new insolvency cases by six months and pushing a majority of existing cases by another six months.

Amid hue and cry raised by investors for the decision, Franklin Templeton was criticized for running all the six schemes as 'credit risk funds', which have a majority of investments in papers with lower credit rating. Though not a violation of regulations, it brought to the fore the sharp practice of the fund managers. This was because in laying down the rules to categorize debt mutual funds, SEBI specified the duration of the securities but not the credit ratings for debt scheme papers.

The schemes are believed to have followed a consistent strategy of investing across the credit rating spectrum and has done well so far many years, across multiple market cycles. Schemes have managed to provide liquidity through these cycles well. COVID-19 pandemic created a severe market dislocation, particularly for the type of investments these schemes hold. The issue was with lack of risk appetite, reduced volumes, and illiquidity for corporate bonds was a broader market issue. The inability of the schemes to meet the daily redemptions was a direct result of the market situations created by COVID 19 as well as the extended lockdown.

Based on the estimation of cash flow, it is expected that each scheme will start returning the money, as shown in Table 3.

Table 3: Franklin Templeton's best estimates of cash flow

Fund	AUM (In Rs. Cr.)	% of Cash flow within 3 months	% of Cash flow within 6 months	% of Cash flow within 1 year	% of Cash flow within 2 years
FIUBF	9679.26	9%	39%	50%	81%
FLIDF	2389.70	1%	19%	45%	74%
FISTIP	5658.22	-	-	1%	34%
FIIOF	1854.61	-	-	-	5%
FICRF	3526.55	-	4%	15%	37%
FIDA	2540.56	3%	14%	21%	45%

Source: Franklin Templeton's FAQ on Maturity Profile / Payments

The main reason for why it's going to take a long time to return the amount to the investors is because the borrowing in the fund that was taken in order to fund the levels of redemptions will need to be repaid. Further due to sustained redemption, many of the funds were forced to liquidate some of the shorter maturity holdings in the portfolio. Hence, the best estimates are only a rough estimate and owing to the uncurtaining on the timelines, they may or may not be met. On June 25, 2020, FTI said the schemes had received Rs. 1,964 crores as routine proceeds and that two schemes that have taken up bank borrowing have repaid their bank loan. Two other schemes are having surplus cash, while in another, the borrowing has come to half at 11.25 percent. These developments appear positive for investors.

Taking shareholders nod

Unitholders will receive a request to vote electronically on the process of winding up the funds under regulation 41 of SEBI (Mutual Fund) Regulation 1996 to authorize the Trustees to take steps for winding up of the schemes. Once this vote is complete and results are notified, the schemes will be able to start monetizing its assets and distributing the investment proceeds in compliance with SEBI regulations.

"Investors affected by the current crisis have no choice, but to wait so that the liquidity gets back to the lower end of the system as and when the lockdown is over and economic activities restart. Only then the AMC will pay back the realizable money," says Omkeshwar Singh, head, RankMF, Samco Securities.



Cover Page



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With the RBI's swift action to forestall any turbulence, there is hope that this is a one-off case, though the economic wheels are yet to roll out of this difficult phase. A sharp liquidity crunch can only be remedied by the solid, guttural roar of running engines.

Side Pocketing

SEBI introduced the concept of side pocketing after the IL&FS fiasco. Side pocketing is made available to debt and money market instruments of all mutual fund schemes and can be opted at the discretion of the fund houses.[4]

On January 24, 2020, FTI side pocketed its exposure of the commercial paper of a leading Indian telecom company - Vodafone Idea. FTI had to 100% write-down the exposure because CRISIL downgraded the credit rating of this paper to BB (below investment grade). At the time of side pocketing, a segregated portfolio for the exposure was created, and hence Investors were allotted units of the side pocketed scheme. Investors need not experience a NAV fall again because the exposure was written down earlier.

On June 12 2020, FTI received an annual coupon payment on the security (partial payment) which was used to repay unitholders of the segregated portfolio fund, and 7.58 percent of outstanding units were extinguished from their folio. Table 4 shows the number of segregated portfolios by various schemes.

Table 4: Number of Segregated Portfolios

Fund Name	FIUBF	FILDF	FISTIP	FIHOF	FICRF	FIDA
Number of Segregated Portfolios	1	2	3	2	3	3

Source: Maturity profile of schemes (cash flow projections) basis Portfolio holdings as on June 15, 2020

Investigation

In a May 7, 2020 press release, the SEBI directed FTI to focus on returning investor money. Media reported in early June 2020 said that SEBI had picked Mumbai-based Chokshi & Chokshi LLP for forensic audit services on the schemes being shut. Amongst several topics that will be under investigation include collusion between the found house and bond-issuing corporates, instances of conflicts of interest of directors or senior officials, and transactions that were prejudicial to the interest of investors in the schemes. The chartered accounting agency is expected to submit its report in 30 days.

SEBI's June 2020 Circular

SEBI released an operational framework to deal with defaulted debt securities post-maturity date/redemption date. The June 24, 2020 circular gives a hope that investors (like mutual funds) can sell the debt securities in the open market to recover the money. This circular gives hope of debt securities that went into a frozen state.

Legal Issues

While FTI is busy with procedures to initiate the windup, it got stuck in a legal tangle. A group of Delhi-based investors has sent a legal notice to the FTI in May 2020. FTI replied, stating they managed the investments as per regulations. The investors then have sent a notice to SEBI seeking its interference in the matter. Meanwhile, in late May 2020, a PIL by an investor association Chennai Financial Markets Accountability (CFMA) was filed in Madras High Court, and notices were served.

In early June 2020, the media reported of a petitioner Amruta Garg, though the Delhi High Court, challenged the notice issued by fund house for e-voting and sought a refund of money. The Gujarat HC was moved by the promoter of Rasna, and the HC stayed the winding-up process till SEBI's forensic report is made public. SEBI filed a letters patent appeal against the HC order stating that the court erred by staying up the critical e-voting process saying it could lead to more delays and put investors at more monetary losses. Letters patent is an appeal against a single judge decision to shift the case to another bench of the same court. Meanwhile, an Extraordinary General Meeting of the members of Franklin Templeton Trustee Services Private Limited in regard to the indemnification of the Directors of the Company is called upon.



Cover Page



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Another dimension that FTI is working on is to provide additional indemnity against default, negligence, breach of trust, and breach of duty. The trustees already, by default, enjoy indemnified cover against acts of omission.

Hearing a plea from FTI, the Supreme Court of India stepped in and directed the High Courts of Madras, Delhi, and Gujarat to transfer all the cases related to the winding up of schemes to the Karnataka High Court and that no other court should entertain the pleas. The bench of Justices Arun Mishra and S Abdul Nazeer questioned how winding up the schemes is a solution, particularly amidst pandemic. The court felt hurried closure of schemes would only result in more litigation and that different courts giving conflicting decisions and resulting confusion. [2]

RESEARCH FINDINGS

1. Investors are always seeking returns ignoring risks involved in the investment. Investor awareness in the area of debt mutual funds is highly necessary.
2. The undue increase in the maturity period of the underlying portfolio of some schemes creates suspicion. This is an area where probably the regulator tightens the norms to ensure sufficient liquidity is available at all times.

CONCLUSIONS

Investors of some of the credit funds of Franklin Templeton need to wait for a period of five years to recover their money fully. The timing could wind up being sooner depending on the sale of underlying assets in the frozen funds in the secondary market, and prepayments or accelerated payments made by the issue of the debts in the funds could quicken the payout.

Winding up of six funds last month triggered shock waves in the local credit markets in India. Winding up of schemes will not lead to money loss for any investors. As the schemes liquidate portfolio holdings subject to market conditions, receive coupon payments, and schedule maturities, the trustees, will start to return money to the investors at the earliest.

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