FIFA detailed comments on TER review – Submitted on 15th March 2023

Dear Sir,

On behalf of the Foundation of Independent Financial Advisors (FIFA), we thank you for giving us an opportunity to introduce ourselves and make a presentation about FIFA and issues related to the mutual fund industry. We share the synopsis of our discussion.

A. **Brief introduction of FIFA**

   During the presentation we shared the objectives of the FIFA and the growth in our membership over the years.

   We now have more than 3000 members spread across 334 cities managing assets under management (AUM) of more than Rs. 2,50,000/- crores.

   Some of our members regularly visit various cities including Tier II and III cities to create financial awareness and for mentoring members to improve their service. We welcome any SEBI representative to accompany our members to Tier II, Tier III cities as that will be a reality check of the industry dynamics at the ground level.

B. **Data on industry growth and drivers of growth.**

   <u>Need for boosting the growth of the mutual fund industry.</u>

   In the year 2013, there was a recognition of the importance of the mutual funds as a vehicle to increase the savings rate in the country especially from the retail investors and a means to increase the financial inclusion across the length and breadth of the country. A need was therefore felt to introduce measures to catalyse the growth of the mutual fund industry.

   To address the above objectives, measures to re-energise the mutual fund industry were introduced in 2013. Amongst other measures, incentives by way of additional expenses over and above the existing total expense ratio (TER) like B-30, service tax on fund management fees, additional basis points in lieu of exit loads were introduced. These measures led to strong growth over the last decade.

   <u>Data points on the growth of the mutual fund industry.</u>

   The growth in the assets under management (AUM) has been Rs. 32 trillion over the last decade.

   This growth has been contributed equally by Net Sales (Rs. 16 Tn) and Investment Returns (Rs. 16 Tn).

   There has also been healthy growth in ETFs with investments being made by EPFO.

Growth has been led by equity investment which in the last 5 years have grown by 30% p.a compared to Debt AUM growing by only 3% p.a.

Contribution of individual investors to the growth of the mutual fund industry

During this period individual investors share in the total AUM of the industry has moved up from 50% to 60% whilst the share of corporates has come down from 50% to 40%.

Over the last 5 years, though the overall industry AUM grew at 15% p.a., the AUM of retail individual investors grew at a healthier 21% p.a.

Distribution and distributors – an important pillar of the mutual fund industry.

Over the last decade the growth in AUM has been led by individual investors. Individual investors especially retail investors continue to use the services of distributors for making their investments.

Growth in investments by individuals has been in equity funds mainly via systematic investment plans (SIPs) recommended by mutual fund distributors (MFDs).

Of the total industry AUM of Rs 40 trillion, almost Rs 20 trillion is in regular plans invested through and serviced by distributors. Individuals MFDs have brought in more than 51% of the Net flows from April 22 to January 23.

The average retail investor account has an investment of Rs 70,770. On this a mutual fund distributor would make around 1% brokerage (assuming all equity funds) which is Rs 770 per annum, after paying GST of 18% this would work out to Rs 600 per annum to service one investor.

In recent years, the mutual fund industry has grown through the tremendous participation of retail investors. MFDs have played a key role in raising funds from non-metropolitan and remote areas where majority of the investors are not aware of the opportunity of investing through mutual funds or not comfortable with technology.

C. Impact analysis on the proposed changes in TER.

Significant changes have been proposed on the limits for TER. We have carried out an impact analysis of the proposed changes. The key findings are as under:

1. Of the total industry AUM of Rs 40 TN, AUM of Rs. 18.53 TN will get impacted.
2. The TER of these schemes will fall from 1.71 bps to 1.29bps a reduction of 25%.

3. TER Slabs / limits were last revised in 2018. From 2018 to 2022 there has been reduction in Equity Oriented funds of 54 bps (-23%) and in case of debt fund of 32 bps (- 25%)
4. The changes now proposed will further reduce the TER of Equity Oriented Funds by 42 bps (-23bps) and Debt Funds by 40 bps (-41%).
5. The impact in Rupee terms is a reduction of Rs 7,737 crores. The total profit of the MF Industry is 7,700 crores. Industry will not be able to absorb such a huge impact.
6. **Trend in AUM of Open Ended and Close Ended Funds:**

   In 2018, regulations also introduced a drastic reduction in TER for close ended funds and reduced the TER to 1.25 for equity-oriented schemes and 1.0 % for other than equity-oriented schemes.

   The drastically lower TER in case of close ended schemes led to stoppage of launch of close ended funds. Close funds which had a corpus of Rs. 2,00,000 crores fell to Rs. 30,000 crores.

   The current proposal for revision in the TER for equity-oriented funds indicates a fall of 44 bps to a TER of 1.37%. This could result in a drastic reduction in net flows and negatively affect the development and growth of the industry and the related benefits.

D. **Global Comparison**

7. The key conclusion arising out of the study on Expense Ratios done by FIFA is that India in 2018 was the third least expensive country for owning equity mutual funds across the globe.
8. The current TER of Equity funds at 1.81 % includes a GST component 0.28%. Thus, the net fees received are only 1.54%. Globally, investors use low-cost plans (direct, ETFs, index funds) but in addition to the fund TER, they also have to pay an advisory fee 1% of AUM and platform charges of 0.25% per annum. This would have made the TER charged by Indian MF industry the lowest in the globe for retail investors.

E. **Low MF penetration**

9. Of the 43.34 Cr individual PAN card holders, only 8 per cent or about 3.37 Cr have invested in mutual fund schemes as of March-end.
10. India is at penetration level of 15% of GDP and a long way to go to deepen the penetration.

F. **Observations during Inspection**

B-30 incentives: B-30 incentives have been instrumental in the increase in retail penetration. However, the level of penetration is far away from the desired levels. B30 incentives should be given to all retail investors across the country irrespective of the pin codes. The Churn & Splitting observed in B-30 inflow is 3% of the total mobilization and 5% of the Retail mobilization. As instances being few, relative to the volume and value of transactions, the same need to be dealt with at the individual level through the AMC. Action needs to be taken by AMCs against the respective distributors and the additional commission paid be reversed and action taken against the distributor.

11. **Transaction cost:** The average cost of brokerage and transaction for debt funds is less than .01% of the AUM. The simple average transaction cost for actively managed open-ended funds is 0.25%. The average transaction cost for passive funds is 0.17%. Hence the transaction costs are reasonable.

    The brokerage cost on transactions is part of the cost of acquiring securities. By limiting the brokerage and transaction cost as a percentage of the AUM, regulations will be indirectly prescribing the maximum portfolio turnover ratio. Purchase and sale of securities must be done based on mandate of the scheme and other investment considerations.

12. **Switches in NFOs:** The amount garnered through NFOs is 10% of the total gross mobilisation of equity funds and the amounts garnered by way of switches of Rs 22,823 is less than 3% of the on the total gross equity mobilisation.

    There is a presumption that all switches are done with a view to get the benefit of higher TER slabs which would be in the interest of the AMC and the distributors Investments, including switches in NFO's may have been done because there is a bonafide case for investing in the scheme for the investor, for partial or total booking of profits in the existing scheme, expectation of better returns from schemes having a smaller AUM etc. Hence whilst there is a higher pricing for new schemes, it cannot be presumed that switches are done only for higher TER's. It will also be observed that switches have been done in passive schemes which would have a lower TER.

G. **Number of MFDs:**

13. **Number of MFDs:** There are only about 1 lakh registered ARN holders of which about 62,000 have an AUM. Only 15,000 ARN holders have an AUM >25 crores. If the proposed reduction in TER is implemented and the cut in TER is passed on to the distribution community it may become unviable for MFD with AUM less than 20 crores to run the business. Unlike Fintech platforms which are financed by VCs and hence can afford cash burns for many years, many MFDs run a viable and sustainable businesses from the income earned by garnering AUM of Rs. 25 crores or more. Any cut in the existing TER will drive out many marginally viable MFDs out of business, thus further shrinking the pool of people serving investors in the small towns and remote areas. Many retail investors will be orphaned and have no one to service them.

14. Instead, of a cut in rates a carrot and stick policy should be adopted penalising the errant AMC / Distributor and giving incentive to others. The Current AMFI practice does not allow repricing of old assets - this restriction needs to be removed.

We are sharing the copy of our presentation as requested by you.

I would also like to share the below documents for your ready reference which were shared earlier:

1. My response on TER
2. Study of expense ratios for MFs

You have pointed out that SEBI would be taking a decision after following the due process of consultation and based on data and assured us that any decision that would be taken would be done by keeping the interest of all stakeholders in mind.

We were unable to discuss on the vision for the future and you were kind enough to suggest that the same would require more time and you would call us at a later date to discuss the same. We look forward to be given an opportunity to do so.

With kind regards,

Dhruv Mehta

Attachments:

[20230310 SEBI Presentation - FIFA.pdf]

[Response on Expense Ratio for MF.pdf]

[Study on Expense Ratio for MF.pdf]