EXECUTIVE BRIEFING

BACKGROUND

The Finance Ministry has called a meeting on 2nd July to discuss steps to revitalize the Mutual Fund Industry.

Foundation Of Independent Financial Advisors, a pan India body of Independent Financial Advisors gratefully acknowledges the opportunity provided to it to participate in this meeting with other industry participants.

The biggest issue facing the Mutual Fund Industry is de-growth and the challenge is how to reinfuse growth. In the last 2 years MF industry has grown globally but India has degrown. MF Assets at 6.58% of GDP are low in term of Global comparison.

The ban of entry load since August 2009 has had the unintended adverse consequence the growth of the Mutual Fund Industry in general and retail distribution and penetration in particular.

The entry load ban had overnight drastically reduced the commission payable to Mutual Fund Distributors and effectively made many sole MF distribution models unviable thereby curtailing the reach and access to these products by small investors. Earlier there were 80,000 to 85,000 IFA's selling MFs this number has dropped by half .

The brokerage offered for selling mutual fund products has become less competitive vis-à-vis some other products.

Inflows in other asset classes (Fixed Deposits, Gold, Insurance premiums) have been growing whilst gross inflows in Mutual funds have significantly declined.

Increased availability and access to the Mutual Fund vehicle as a saving product is the first most important measure of INVESTOR PROTECTION as it enables him to diversify his portfolio from real assets and less productive investment products.

With Mutual Funds being push products, the investor needs to be channelized into buying these compared to other products unlike gold and fixed deposits. The industry needs a large fleet of foot soldiers - a large and vibrant distribution force – spread across the length and breadth of the country - to spread this message and provide accessibility.

An economically feasible distribution model, which provides adequate incentive to the distributors, is necessary for this to happen.

FACTORS IMPACTING GROWTH

The regulatory changes initiated since August 2009 have had the highest negative impact on the industry, such as;

1. **Reduction of the number of distributors selling Mutual Funds**
2. **Degrowth in Industry - Net Redemption in Last 2 years**
3. **Poor geographical penetration**
4. **Low equity participation in both urban and retail centres**
5. **Large Corporate participation and Low Individual participation**

DISTIRIBUTOR REMUNERATION

An average retail distributor with 100 clients currently earns a gross income of Rs. 26, 000 per annum. This is clearly inadequate to attract and retain distributors in this field. Such a distributor has seen a decline of 33% from his already low income post the ban of entry load. **(See Annexure 1-A)**

An IFA does not only distribute equity products but also debt products. Based on the AUM as on 31st March, 2012, the AUM weighted average commission the IFA would earn would be 30bps **(See Annexure 1-B)** and if he were to get fresh subscription of 10% in case there were an entry load of 2% his yield would move up to 0.50% which seems to be the minimum amount to ensure viability in the current context.

ROLE OF LOADS:

The role of entry and exit loads has been very sadly misconstrued as tools only for remunerating the distributors. In USA, the home of Mutual fund Industry Entry and Exit loads were introduced to discourage early retirals affecting long term investors. Entry and Exit loads were pooled into a single load account and used to meet the marketing expenses of the fund house. In an Industry where profit margins were wafer thin load pool helped finance market expansion via intermediaries and thus avoiding shifting the entire market development costs to the fund houses which can ill afford to bear them, given their low margins. **Even today in USA, the load regime continues and is not banned**.

SUGGESTIONS:

1. **REMOVAL OF THE BAN ON ENTRY LOADS: THIS CAN FACILITATE**

   - **Restoration of Entry Loads**
   - **Allow Multiple plans like in US**
   - **Introduction of Single Cheque system and Variable Load**

2. **Increase of Expense Ratio's**
3. **– Setting up SRO – to prevent misspelling and wrongful churn**
4. **Tax Incentives for long term savings and pension plans**
5. **Abolition of KYC for PAN Card and Bank account holders**

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BACKGROUND

The opening up of the Indian Economy in early nineties under the stewardship of our Hon'ble Prime Minister, as the then Finance Minister, has provided multitudes of opportunities for channelizing the retail savings into the growth and development of the nation. Within the ambit of the capital markets, one of the industries which has established itself as an important means of channelizing household savings into the Capital Markets is the Mutual Fund Industry. Regulation of this Industry was entrusted to the Securities and Exchange Board of India ("SEBI"). SEBI has done a wonderful job of regulating the Indian Financial markets and protecting the interest of the Indian investors over the years. The Mutual Fund Industry has seen a phenomenal growth right until the global financial turbulence in 2008.

The regulations had evolved gradually till 2008. Posts the financial turbulence of 2008, a spate of new regulations have been enforced by SEBI including the ban on entry loads. Recently to rekindle the growth and development of the Mutual Fund industry SEBI has initiated the process of discussions with various industry participants and has invited suggestions from Mutual Fund distributors also in this regard.

Foundation Of Independent Financial Advisors, a pan India body of Independent Financial Advisors gratefully acknowledges the opportunity provided to it to voice the concerns of and provide suggestions from the distribution industry while formulating policy initiatives and regulation in this connection.

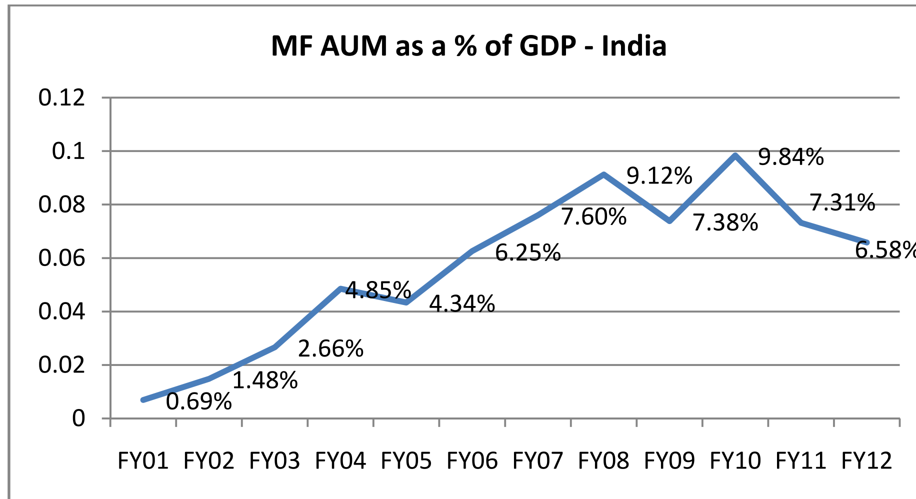
ISSUES:

The biggest issue facing the Mutual Fund Industry is de-growth and the challenge is how to reinfuse growth. FIFA believes that along with its avowed goal of Investor Protection, the regulator can play a pivotal and critical role to facilitate the balance growth of the Mutual Fund industry through its regulatory roadmap. On 30th June, 2009, SEBI released a circular banning entry loads effective 1st August, 2009. The unintended adverse consequence of banning the entry load has been on the de-growth of the Mutual Fund Industry since 2009 in general and retail distribution and penetration in particular. The entry load ban had overnight drastically reduced the commission payable to Mutual Fund Distributors and effectively made many sole MF distribution models unviable thereby curtailing the reach and access to these products by small investors. *After the compensation norms for distributors were altered (i.e. the removal of entry load in 2009) the brokerage offered for selling mutual fund products has become less competitive vis-à-vis some other products. Thus the "push" for the products has also weakened*. (Source: PWC Report 2012).

Comparison of Brokerage offered various financial products

Asset Class	Upfront Commission
Company Fixed deposits	2-3%
Insurance Plans	15-25%
MF distribution	0.5%

The growth of the MF industry is very important for the development of an efficient capital markets as it channelizes savings into both debt and equity markets. For the widespread growth of the industry it is imperative to provide access of this wonderful, most transparent and least cost Mutual Fund product as a household savings instrument. Access will lead to awareness. Trying to create awareness will not be meaningful unless supported by adequate availability and access to these products. The level of penetration of Mutual Funds in India is abysmally low in the global context.



(Source: AMFI)

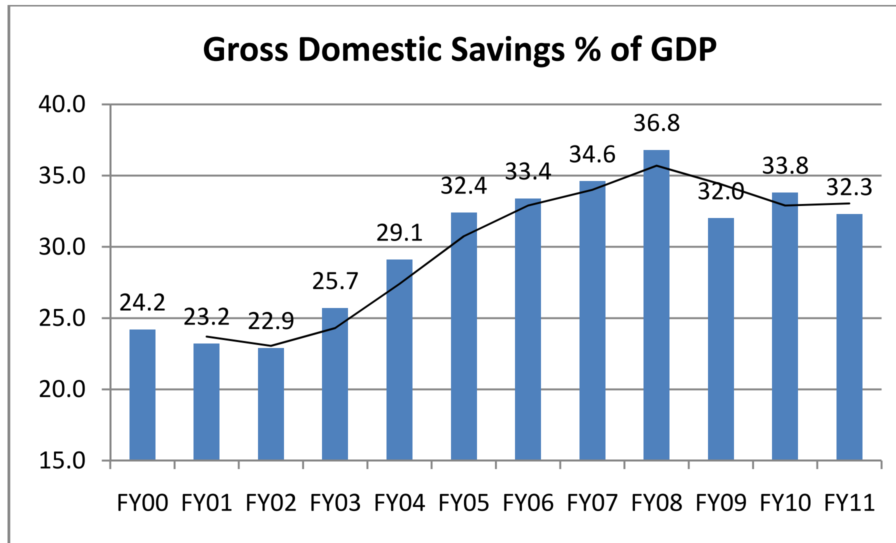
It is pertinent to note that Post 2009 as compared to other countries, the Indian MF industry has seen a dramatic de-growth which could be attributed to regulatory changes unique to the Indian market.

A comparative illustration of the growth in various key global markets is given below:

Worldwide Total Net Assets of Mutual Funds					
(USD in bn)	**2007**	**2009**	**CAGR 2007-09**	**2011**	**CAGR 2009-11**
Global	26,131.5	22,952.8	-6.3%	23,779.9	1.8%
United States	12,001.5	11,120.2	-3.7%	11,621.6	2.2%
UK	897.5	729.1	-9.9%	816.5	5.8%
Brazil	615.4	784.0	12.9%	997.9	12.8%
Russia	7.2	3.2	-33.4%	3.1	-1.7%
China	434.1	381.2	-6.3%	339.0	-5.7%
India	108.6	130.3	9.5%	87.5	-18.0%
Source: ICIfactbook.org					

NEED FOR PUSH OF MF IN THE HOUSEHOLD SAVING PORTFOLIO

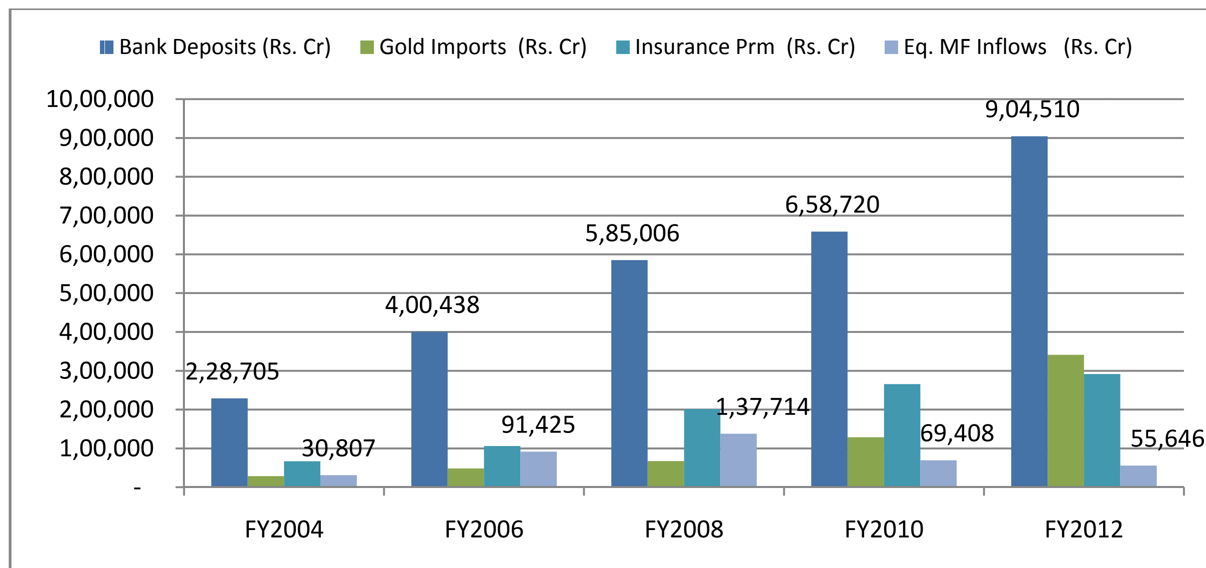
Household savings which had been growing very significantly over the last decade have seen a recent dip.



(Source: AMFI)

Traditional avenues like insurance, gold and fixed deposits dominate household savings.

Comparison of inflows into various asset classes



(Source: AMFI)

It has been observed that inflows in all asset classes has been growing consistently from last several years except Eq. Mutual Funds which has seen a sharp dip from FY2008 onwards.

Comparison of inflows into various asset classes

Year	Bank Deposits (Rs. Cr)	Gold Imports (Rs. Cr)	Insurance Prm (Rs. Cr)	Eq. MF Inflows (Rs. Cr)
FY2004	228,705	28,427	66,654	30,807
FY2005	175,558	46,165	82,855	41,586
FY2006	400,438	48,302	105,876	91,425
FY2007	502,886	63,046	156,076	97,624
FY2008	585,006	67,047	201,351	137,714
FY2009	637,170	105,101	221,785	35,500
FY2010	658,720	128,594	265,447	69,408
FY2011	715,140	195,500	291,605	74,082
FY2012	904,510	341,000	291,605*	55,646

(Source: AMFI)

*- Insurance Inflows for FY12 is not available.

Clearly over the long term households investing in fixed deposits and gold will have difficulty in beating inflation. Real estate as an asset class cannot provide avenues for systematic savings. However these are perceived to be safe asset classes vis a vis Mutual Fund investment. It is quite clear that savings other than these in the Indian context are going to be "push products" compared to traditional investments like real estate, gold and fixed deposits. Very apparently investor awareness through different programs; has not led to conversions or investments. As an industry the Mutual Fund distributors are the only people who can reach out individually to the investors, explain the intricacies of financial investments and encourage them to invest. However, the regulatory changes effected since 2009 have resulted in lack of motivation amongst distributors who were willing to support their clientele.

There is relatively low level of understanding and knowledge of financial products and lack of self-propelled actualization to buy even amongst the educated class in metropolitan and Tier I cities. From a national perspective also, it is essential that a large part of household saving gets channelized to capital market instruments to enable capital formation and consequent economic growth and rise in per capita income. Hence both from an individual investor, household and national perspective the growth of the Mutual fund industry is linked and is a catalyst for growth.

Increased availability and access to the Mutual Fund vehicle as a saving product is the first most important measure of INVESTOR PROTECTION as it enables him to diversify his portfolio from real assets and less productive investment products.

IMPORTANCE OF A VIBRANT DISTRUBTION NETWORK

With Mutual Funds being push products, the investor needs to be channelized into buying these compared to other products like gold and fixed deposits. The industry needs a large fleet of foot soldiers - a large and vibrant distribution force – spread across the length and breadth of the country - to spread this message and provide accessibility. The IFA channel comprising of individual distributor/advisors have been providing this service in a very cost effective manner and also by building personalized relationship with their clients, the investors.

IFA's are an inspired and responsible distribution force to reach the Mutual Fund products to the end customers. An economically feasible distribution model, which provides adequate incentive to the distributors, is necessary for this to happen.

The failure of the NPS on account of the lack of a distribution mechanism is a glaring example. Mutual Fund houses which have adopted the model of only direct marketing have also not grown. Since inception of the Mutual Fund industry the practice of charging Advisory fees from the investors has never been in vogue. Nor have any investor awareness programs highlighting of the need of IFA's and their advice have been undertaken by the Regulator, AMFI or the fund houses themselves. Investors are not even aware that they need to pay their distributors for the service they are getting.

FACTORS IMPACTING GROWTH

The regulatory changes initiated since August 2009 have had the highest negative impact on the industry, such as;

6. **Reduction of the number of distributors selling Mutual Funds**

Till about a year or two back, there were 80,000 to 85,000 IFA's selling MFs. After SEBI introduced know-your-distributor (KYD) norms in 2010, only about 48,000 distributors complied with the KYD process. Agents, who are not compliant with KYD norms, are not entitled to get commissions. (Source: Mint Article on May 14, 2012 by Kayezad E Adajania). The removal of entry load has had a negative impact since this specifically impacted the economic viability of the IFA community with only 50% of the registered ARN holders getting their KYD done post the abolition of entry load.

7. **Degrowth in Industry - Net Redemption in Last 2 years**

The Mutual Fund Industry, plagued by net redemptions by investors and adverse global and local market conditions, shrank by 16.5 % to 5, 87,659 crores INR as on 31 March 2012 from 7, 03,669 crores INR as on 31 March 2011. (Source PWC report 2012).

8. **Poor geographical penetration**

The top five cities (Mumbai, New Delhi, Bangalore, Kolkata and Chennai), contribute over 71% of the total AUM, with Mumbai alone accounting for more than 42%. (Source: PWC Report 2012)

9. **Low equity participation in both urban and retail centres**

Equity assets comprise only 34% of the assets of Mutual Fund Industry in India compared to 52% in US indicating the need for greater penetration. The Mutual fund industry is primarily debt-oriented with debt funds (including liquid funds) forming 64% of the AUM. Remaining 2% goes into ETF. As in the past, increased equity participation is the need of the hour for the mutual fund industry. An overwhelming majority of the funds garnered from the urban non-retail segment are short term investments. We need to look at other investors like retail investors and high net worth individuals (HNIs) in the urban and semi-urban areas. This will help fulfill the objectives of financial inclusion. (Source: PWC Report 2012). Getting investors to invest their saving in equities requires greater effort in terms of creating awareness, investor education of the risks and rewards and therefore distributors need a greater financial incentive to sell equity linked products.

10. **Large Corporate participation and Low Individual participation**

In USA, households and Individuals account 85.6% of assets under management compared to 14.4% for corporates. (Source: ICIFactbook.org) In contrast in India Individuals account for 54% (equally divided between retail and HNI) of the AUM and Corporates 46% (Source: AMFI Data). This indicates the potential of increasing individual and household participation in Mutual Funds.

DISTIRIBUTOR REMUNERATION

The retail investment market is characterised by poor investor awareness and low levels of understanding. The investors are often unaware of their need for particular type of products. Even if they are aware of their needs, the long-term nature of some investment products deters some investors from buying because they find it hard to determine whether it is worth it, thereby implying the benefits of these investments have to be clearly outlined to the investor.

Generally, it is more expensive for a distributor to reach out to Individual investors than to a corporate investor. While an average retail investor folio has about 35,000 INR of assets, an average corporate investor's folio has 59 lakhs INR of assets. Hence a distributor will need to reach around 170 retail investors to get the same AUM as a single corporate folio, which acts as a relative disincentive to chasing and capturing individual retail investors. (Source:

PWC Report 2012). It is worthwhile to keep in mind that mutual funds were originally aimed to provide individual investors with the opportunity to make long term capital market investments.

An average retail distributor with 100 clients currently earns a gross income of Rs. 26, 000 per annum. This is clearly inadequate to attract and retain distributors in this field. Such a distributor has seen a decline of 33% from his already low income post the ban of entry load. **(Refer Annexure 1-A)**

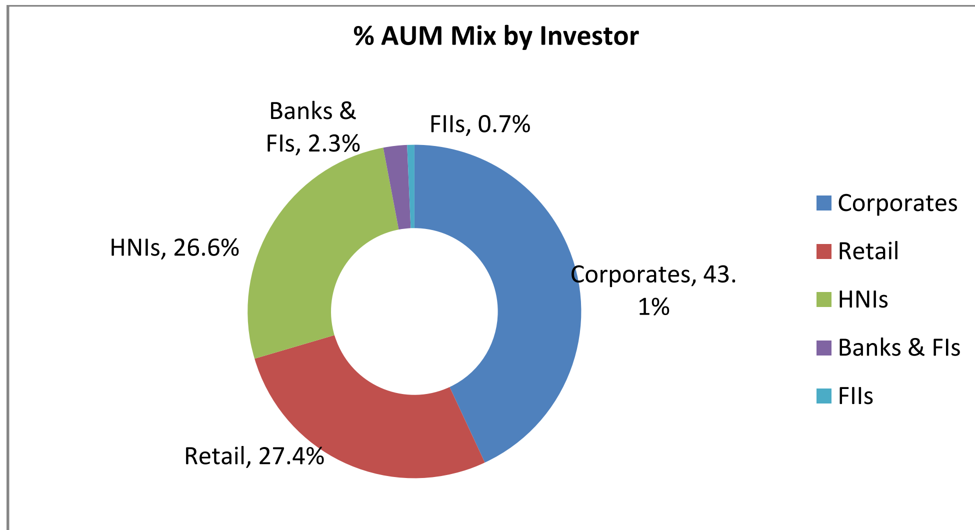
Moreover, despite the higher upfront cost of acquiring a retail investor, the sticky nature of retail investors indicate that retail investors break even and are actually more profitable than corporate clients in the long run. Once again to get a greater proportion of individual investors one would require an upfront distribution fee due to cost that this process inherently entails.

Most of the investments in this market are currently the result of an advised process which the IFA in urban and rural cities does door to door. The process typically includes PAN Card application, bank account opening, capital gains statements, Income tax queries etc. among other things. Investors who are advised by IFA's tend to build a long term relationship with them as they depend largely on the advice given to them. Therefore, a relationship is built based on trust and the IFA becomes a trusted advisor to the investor. The IFA raises the investor's awareness of needs and helps him to make the decision to take action to address that need. All this requires investment of time and effort which need to be rewarded for an IFA to sustain his business. To broad base the distribution there has to be a large fleet of distributors on the ground to ensure optimum penetration.

Prior to its abolition the entry load was being charged only on equity and balance funds, that too on investments below a particular ticket size of 2 to 5 crores. Debt funds carried no load. Point to be noted is that while the regulations allowed loads to be levied the market place did not have loads on all products and were levied on investments in equities below a particular size. An IFA does not only distribute equity products but also debt products. Based on the AUM as on 31st March, 2012, the AUM weighted average commission the IFA would earn would be 30bps **(See Annexure 1-B)** and if he were to get fresh subscription of 10% in case there were an entry load of 2% his yield would move up to 0.50% which seems to be the minimum amount to ensure viability in the current context.

INVESTOR PROFILE:

The investor profile of the Mutual Fund Industry as on 31st March, 2012 is given below:



DISTRIBUTION CHANNELS

The investors in Mutual Funds are serviced by three main distribution channels namely:

1. Banks
2. National Distributors
3. IFAs

We believe that the abolition of entry loads has had a mixed effect. It has been beneficial for the Corporate and Super HNI, but has had a negative impact on the retail investor as can be seen from the drop in number of distributors selling mutual funds. Keeping in mind the different customer segments, distribution channels, low per capita income, low penetration we believe the regulations need to allow flexibility in the pricing structures.

ROLE OF LOADS:

The role of entry and exit loads has been very sadly misconstrued as tools for remunerating the distributors. In USA, the home of Mutual fund Industry entry load was primarily introduced to disadvantage the later entrant vis-à-vis the early investor. The load imposed was on the price and not on the investor as SEBI mistakenly presumed. Exit loads were introduced to discourage early retirals affecting long term investors. Exit and entry load were pooled into a single load account and used to meet the marketing expenses of the fund house. In an Industry where profit margins were wafer thin load pool helped finance market expansion via intermediaries and thus avoiding shifting the entire market

development costs to the fund houses which can ill afford to bear them, given their low margins. **Even today in USA, the load regime continues and is not banned**.

Mutual Fund products are generally long term savings products. Entry and Exit Loads also act as are a deterrent for considering mutual funds as short term investments. As such manufacturers have used them only for long term savings products. Entry /Exit loads were used in Equity funds and Exit loads in long term debt funds.

SUGGESTIONS:

1. **PRICING:**

A) Restoration of Entry Loads

For retail penetration and geographic expansion, restoration of entry load is essential.

B) Allow Multiple plans

The mutual funds should be allowed not just to continue the current no load plans but also to allow plans with entry/exit loads thus giving the customer the flexibility of choosing a structure suitable to him. Albeit safeguards can be put in place to prevent mis-selling and strong deterrent penalties could be prescribed for mis-selling. This will enable multiple pricing models with ceilings on Entry / Exit loads and staggered exit loads depending on the period of holding. Investors could choose the pricing model and different distribution channels could adopt the plan suitable to them. This will leave funds to offer different distribution and service arrangements with differing needs.

A similar model is in use in the US from 1980 and has been very successful in facilitating the Growth from $ 134 US billion in 1980 (6.6% of GDP) to currently $ 11 Trillion and at 75% of GDP. It may be noted that US abolished compulsory fixed commission in 1980 when per capita income was $ 10000. After more than 30 years India is currently at per capita income of $ 1500.

C) Introduction of Variable Load and Single cheque

As discussed herein above as Mutual Fund products are Push products it is not possible to expect the investors to pay for the advice. Investment advisors have to seek prospective investors and work hard before their efforts result in investments. When they move out seeking appointments with prospective clients offering products (not advice) it is too much to expect fees for their efforts. It is a fundamental truth that advice sought will be willingly paid for and advice offered is considered free and often ignored. Therefore the concept of variable load with a single cheque will not work until and unless a minimum load is made mandatory. Merely because the AMC's are unable/unwilling to pay appropriate commission to distributors, the distributors are expected to project themselves as advisors and be able to justify and convince each investor to pay the upfront fees.

D) Expense Ratio's for MF

A practical approach to enhancing Total Expense Ratio needs to be adopted. The current slabs which have been set up at First 100 crore, Next 100 Crore need to be revised upwards in line with inflation. Lower slabs make it more difficult for new fund schemes to grow as the break-even level for new fund schemes have increased substantially.

2. <u>Distributor Regulations – Setting up of an SRO</u>

A SRO needs to be set up. SRO should be ideally set up by the trade body. AMFI is a trade body of the manufacturer. If it is transformed into a SRO, it would lead to conflict of Interest. SEBI should have a consultative approach with the distribution community in this regard and involve FIFA, which is a representative body of the IFA community, in the process. SRO can take over the responsibility of licensing Distributors with proper rules and regulations governing their registration, code of conduct, qualification and practice. They can play an effective role in preventing mis-selling.

3. <u>Tax Incentives</u>

Introduction of 401 K like Plans or other tax saving incentives for long term investments in Mutual funds. Extension of Rajiv Gandhi Scheme for investments in Mutual Investments.

4. <u>KYC</u>

Abolition of KYC for PAN Card and Bank account holders

5. <u>Other Suggestions</u>

- Frequency of issuance of circulars and change of regulations should reduce.

- Sufficient time to be given to distributors to understand and adapt to the change in regulations.

- Views of all stake holders to be taken into account before making regulatory changes.

- To penalize those distributors found guilty of mis-selling or indulging in malpractices and not to bring about regulations which have far reaching and adverse implications.

- Due Diligence Process for IFAs need to be suitably modified.

- Need to counter negative and adverse media reports about the mutual fund industry.

Annexure –

1A- Calculation of Gross Income of an Average Retail Equity Investor

Average retail Portfolio - Rs. 35000
No. of Clients - 100

Commission structure pre 2009 (Entry loads applicable)

Particulars	Corpus	Assets	Brokerage	Amount	Clients	Income
Trail Commission	35000	100%	0.5	175.0	100	17500.0
Upfront Commission	8978	26%	2.5	224.4	100	22443.8
Total				**399.4**	**100**	**39943.8**

Commission structure post 2009 (Removal of entry load)

Particulars	Corpus	Assets	Brokerage	Amount	Clients	Income
Trail Commission	35000	100%	0.5	175.0	100	17500.0
Upfront Commission	8978	26%	1.0	89.8	100	8977.5
Total				264.8	**100**	**26477.5**

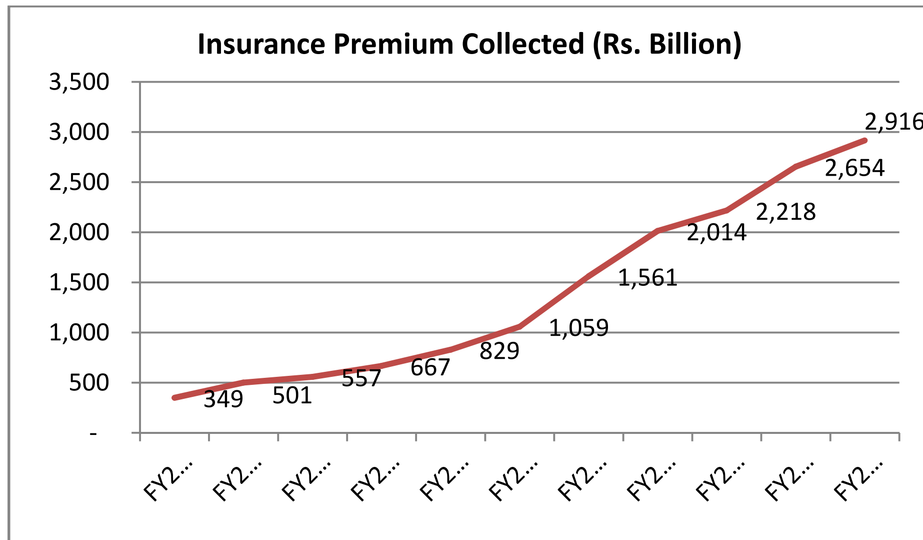
Revenue loss post removal of entry load	**13466.3**
Drop in percentage terms	**33.70%**

1B- Calculation of Weighted Average Commission:

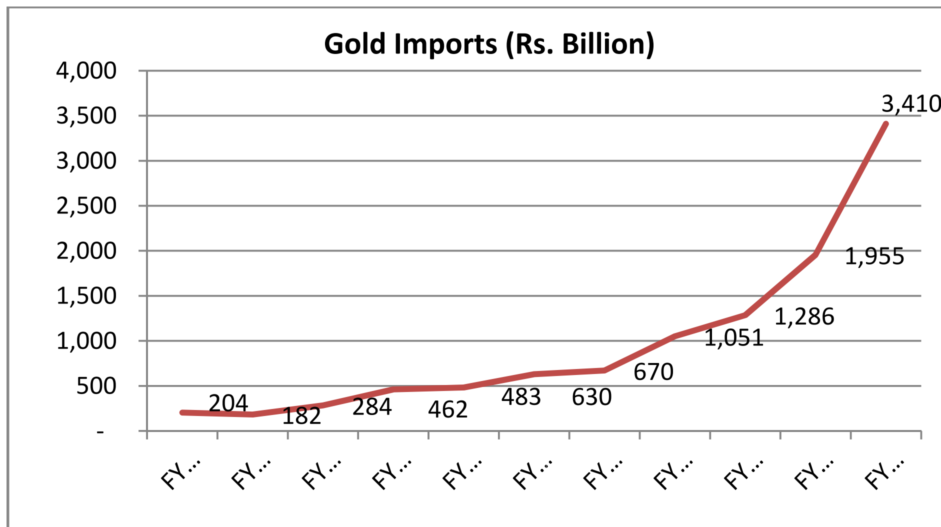
Calculation of Distribution Commission			
Type of Asset	**%of Aum**	**% Commission**	**Wt. Avg. Yield**
Trail Commission			
Equity*	34.30%	0.50	0.172
Debt $	10.00%	0.50	0.050
FMP	25.00%	0.05	0.013
Liquid Plus	15.00%	0.10	0.015
Liquid	14.00%	0.05	0.007
ETF	1.70%		-
Total trail	100.00%		0.256
Upfront	8.80%	0.75	0.066
Total Commission as a % of Total Assets			0.322
Gross Sales	55,646.00		
Equity AUM	**216,936.00**		
%	25.65%		

* Equity includes Equity, Balalnced Funds and FOF
$ Debt includes Short Term, Income AND gilt
- Upfront is paid on Gross Sales -
AUM at beginning of the year - as on March 2011

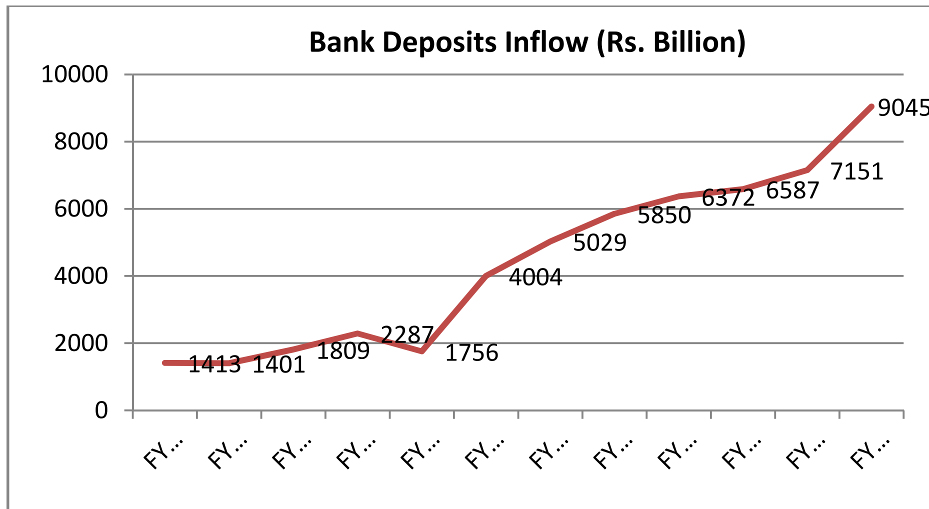
Annexure – 2:



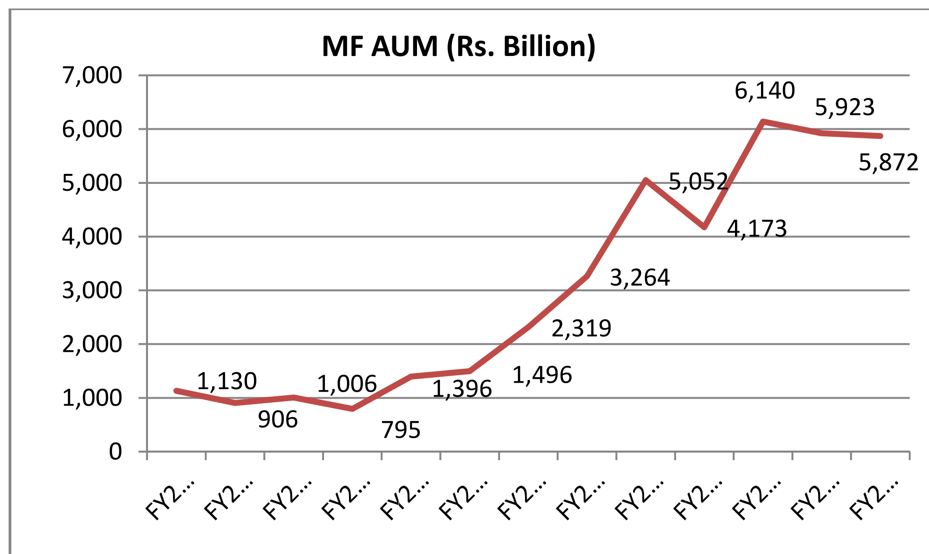
(Source: IRDA Annual Report 2011)



(Source : Assocham Report)



(Source : Bloomberg)



(Source : AMFI)