Is there a silver lining?

The Indian mutual fund industry

Confederation of Indian Industry

Mutual Fund Summit 2012

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pwc

Chairman's message

The mutual fund industry, today presents a picture of opportunity and challenges. As the industry sensitises itself to the changing regulatory landscape, business strategies are endeavouring to respond to these developments. Amidst this changing business and regulatory environment, asset management companies and all service providers, including distributors, have to re-examine their business models and embrace the changing business landscape.

Notwithstanding the recent growth challenges, mutual funds continue to be an efficient vehicle offering varied investment products at a reasonable cost to households to participate in the long-term growth prospects of our economy.

This report by PwC titled "Is there a silver lining?" attempts to take an all around view of the dynamics and have focussed on looking for the hidden opportunities.

We would like to thank PwC for their efforts in preparing this report and hope that you find it useful and interesting. We would welcome any comments and observations, to help us prepare better for the next summit.

A Balasubramanian
Chairman - CII Mutual Fund Summit 2012 and
Chief Executive Officer
Birla Sun Life Asset Management Co Ltd

Foreword

We take pride in continuing our association with the CII Mutual Fund Summit. This document presents the perspective of industry stakeholders, along with our points of view, on the current scenario in the mutual fund industry.

While a lot has been said about distribution, we have attempted to take an all-encompassing view of the issues and have focussed on looking for the hidden opportunities. We have tried to examine the business structure and its operations in order to find ways of stimulating redesign and innovation.

We have also covered regulatory changes—both past and anticipated—as well as some global trends to give readers a wider perspective.

We thank the industry stakeholders who shared their insights to help shape this document.

We believe this document will provide some key perspectives and will raise questions that will lead to meaningful discussions and outcomes that benefit the industry as a whole.

As always, we welcome your suggestions and inputs to help us improve our thought papers and reports on the industry.

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Prologue

There is an oft-quoted saying believed to have originated as a Chinese proverb: "May you live in interesting times". It is often not interpreted with a positive connotation!

At present, it would be fair to say that the Indian mutual fund industry is living in interesting times. It remains to be seen how positively that can be interpreted.

The last few years have seen a series of events, both within and outside the Indian economy, which have had a deleterious effect on the industry. The world as we knew it has changed in many ways.

While the financial meltdown of the last decade and its consequences are still being felt, many are already talking of another one originating in the Euro zone. The global economic slowdown was a natural consequence of the events of 2007-8 which has led to a gloomy investment climate.

For obvious reasons, most investors appear to have adopted a more cautious approach.

The situation has not been very different in India, with the potential addition of other issues to contend with. The economic outlook does not appear to be very encouraging in the near term, nor does the investor community appear very confident of a return to growth, all of which do not augur well for a vibrant and healthy investment climate.

Indeed, these tough times can be seen as an opportunity for the industry to reinvent itself. Perhaps, the industry has moved beyond the first phase, in which it established itself as a part and parcel of the investment matrix. The industry needs to evolve again to strengthen its position and proposition. It is probably time to question established wisdom and explore alternatives.

In the present situation, there may be no single 'silver bullet' solution, but it will require a multitude of initiatives to be taken across the entire spectrum of activities of a mutual fund.

We have attempted to take a wide-angled view of the industry and looked at different aspects where challenges are faced.

As another proverb says, 'necessity is the mother of innovation'. Perhaps an adverse situation is the right time and place for reflection, innovation and re-invention.

Snapshot of 2011-12

The mutual fund industry, beset by net redemptions by investors and adverse global and local market conditions, shrank by 1.6% in terms of assets under management during the year FY2011-2012.

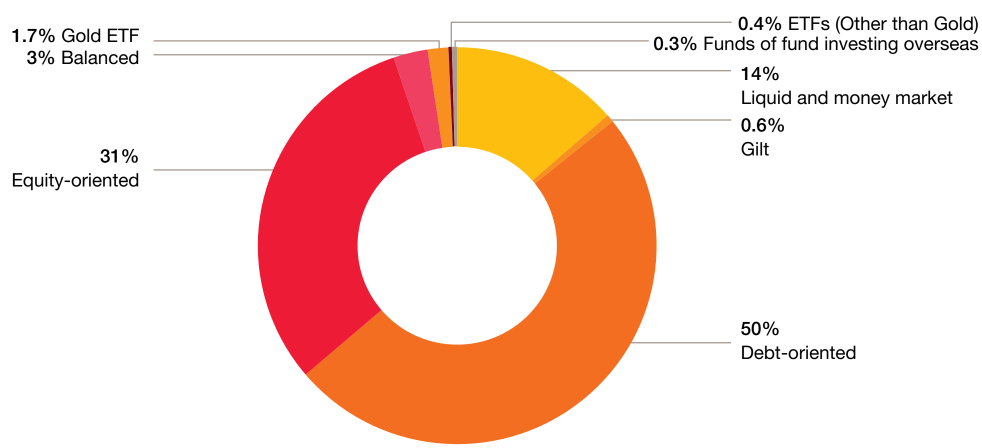
The benchmark BSE Sensex and the assets under management (AuM) for the mutual fund industry have risen in tandem. Booming markets in 2006 saw increased investor participation in the industry, leading to fund inflows enabling the AuM to grow at a pace greater than the Sensex.

However, volatile market conditions in the last two years have led to net withdrawals by investors to the tune of 49,406 crore INR in FY 2010-11 and 22,023 crore INR in FY 2011-12, leading to a further drop in AuM, in addition to the drop caused by adverse market movements.

The mutual fund industry is primarily debt-oriented with debt funds (including liquid funds) forming 64% of the AuM. As in the past, increased equity participation is the need of the hour for the mutual fund industry.

AuM evolution of the Indian mutual fund industry *(Source: AMFI and BSE data)*

AuM split between fund types as on 31, March 2012 *(Source: AMFI data)*



Key trends

The period from 2006 to 2012 saw a number of major events, a very significant one being the global meltdown in the banking and financial services industry (BFSI), which had knock-on effects on almost all business sectors.

Considering that we now live in a connected world, India faced its own share of consequences although companies in the BFSI segment remained relatively unaffected by the turmoil seen in the Western world. It seemed as though the tighter regulatory regime had paid a dividend in an imploding global scenario.

The relevant indices and statistics—including stock markets—reflected the stress the Indian environment went through. This document examines the various trends, outcomes and issues pertaining to the Indian asset management industry against this backdrop.

The Sensex rose from the levels of 14,000 in February 2007 to a dizzying peak of 21,000 in a span of a year (January 2008) and then plunged to levels below 9,000 in the next year (March 2009)! This was despite the fact that the GDP grew by 9.3% in FY 2007-08 and 6.8% in FY 2008-09. Since then, the market has largely been in the range of 15,000 to 17,000, thanks to the prevalent global and local geo-political uncertainties.

Regardless of all the above factors, the Indian asset management industry has racked up an absolute growth of over 50% (31 March 2007 to 31 March 2009), which is no mean feat. Over the same period, many mutual fund schemes actually delivered a positive alpha! This is something the common investor is largely unaware of.

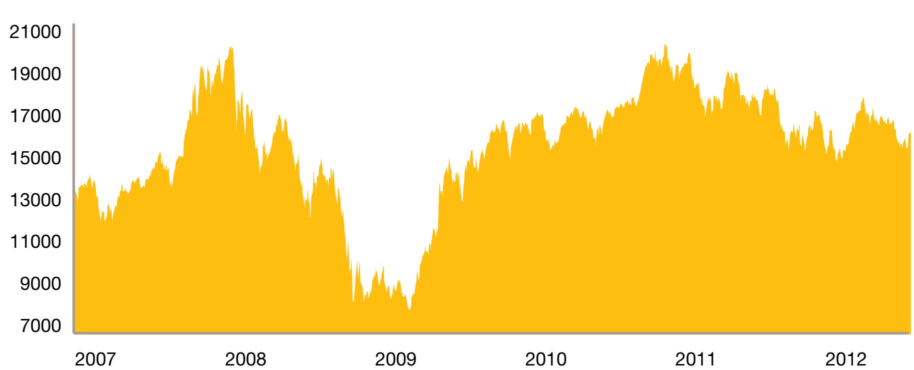
Yet the industry again finds itself facing several challenges. Factors such as softer economic outlook, an uncertain investor and regulatory changes (e.g., the removal of the entry load in 2009) have led up to this situation.

Mutual funds are one of the several options that investors explore for investing surplus funds. In a deposit-dominated market like India it is important for mutual funds to be able to offer differentiated risk-rewards and gain shelf-space. With many seemingly similar offerings from multiple mutual funds unable to clearly communicate their superiority, a less informed investor may find it difficult to make a choice. This uncertainty leads to a weakened 'pull' for the product.

On the other hand, in an open architecture distribution scenario, distributors are well aware of the differential incentive and brokerage structures across products. After the compensation norms for distributors were altered (i.e. abolition of entry load), the brokerage offered for selling mutual fund products has become less competitive vis-à-vis some other products. Thus, the 'push' for the product has also weakened.

The question, therefore, is this: how can the mutual fund products regain the shelf-space they seem to have lost in a scenario where investor knowledge and awareness is relatively poor?

BSE Sensex *(Source: BSE data)*



Against this backdrop, the industry has seen the number of mutual funds grow from 32 to 44 over the last six years. The number of schemes has grown from 779 to 4,473 (counting various options of a single scheme as separate schemes) in the same period. Further, there have been 18 new entrants through the joint-venture (JV) or acquisition route, which include the following:

- Nomura
- KBC Bank
- L&T Finance
- Goldman Sachs
- Natixis Global AMC
- T Rowe Price
- Pramerica

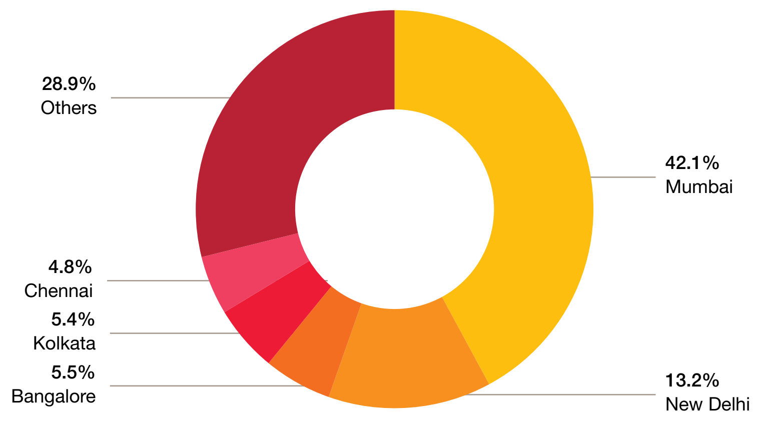
There is one reported proposed entry – of Schroder Investment Management through the acquisition of a significant minority stake in an existing AMCor trust company and also one reported proposed exit, viz. Fidelity

This growth serves to demonstrate that, at a fundamental level, there are many significant global and local players that consider the Indian mutual fund industry to be attractive. It is necessary to understand the mix of investors, distributors, types and number of schemes as factors that contribute to a sustainable and profitable operating model.

The data as on 31 March 2012 relating to geographic contributions to the total AuM tells a revealing story.

The large number of corporate investors contributing to the skew towards the debt-oriented or non-equity AuM is mirrored by the disproportionate contribution from Mumbai. 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%.

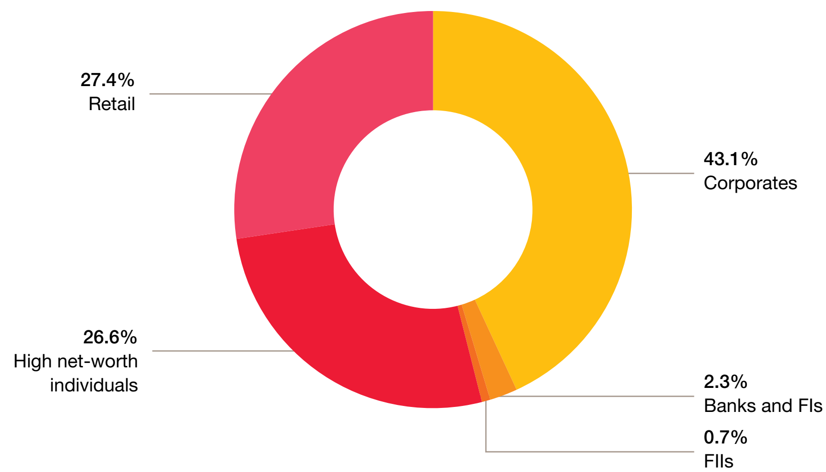
AuM by geography as on 31 March 2012 *(Source: AMFI data)*



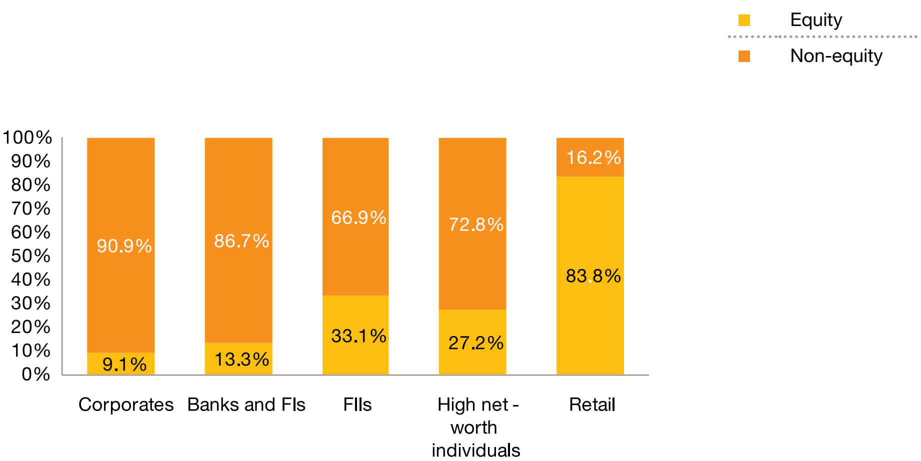
The statistical analysis throws up a few more facts:

- Over 43% of the AuM is from corporate investors.
- Over 90% of corporate investor funds are invested in non-equity schemes.
- Almost 85% of corporate investors keep their funds in schemes for less than 12 months.

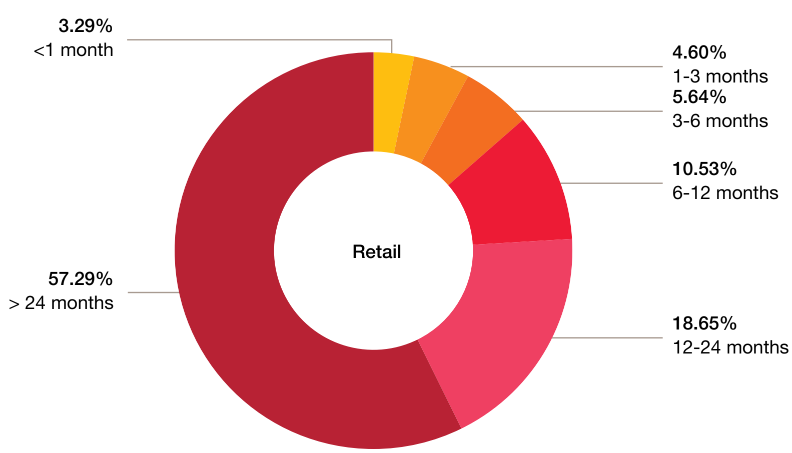
AuM mix by investor type as on 31 March 2012 *(Source: AMFI data)*

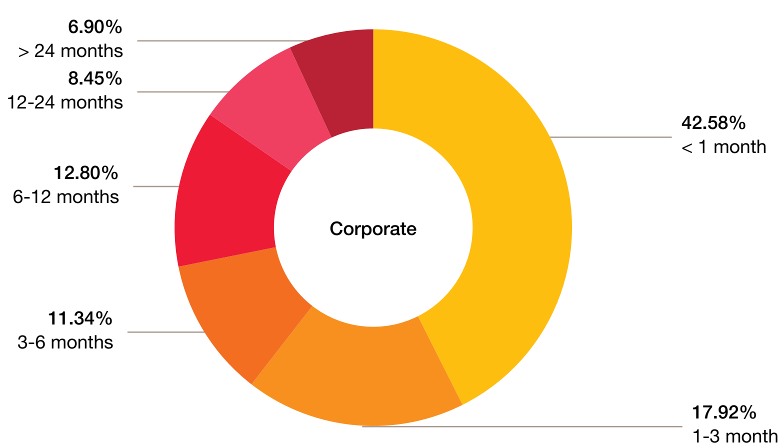


AuM Mix of investment by investor type as on 31 March, 2012 *(Source: AMFI data)*



AuM ageing of retail and corporate folios as on 31 March, 2012 *(Source: AMFI data)*





Thus, an overwhelming majority of the funds garnered from the urban non-retail segment are short-term investments. Further, this is not a short-term trend as it has been noticed over a period of a few years. Therefore, if the industry wants to change the age profile of the funds it has at its disposal, it needs to seriously look at the other investors i.e. retail investors and high net-worth individuals (HNIs) in the urban and semi-urban areas. This will also help fulfil the objectives of financial inclusion.

This is not to say that corporate investors should not be encouraged to invest in mutual funds as this leads to channelising corporate surpluses into the capital market in a structured fashion. At the same time AMCs could do well to have a sharper focus on the retail investor.

It is good to remember that mutual funds originally aimed to provide individual investors with the opportunity to make long-term capital market investments. Earlier, 'long-term' referred to periods of five to ten years. The perception in recent times of long-term is probably that of two to three years. This is a period not nearly enough for a fund manager to demonstrate an alpha that justifies continued investment.

Key challenges

Distribution- and penetration-related challenges

Traditionally, large distribution networks were developed by the Life Insurance Corporation of India and the Unit Trust of India for their own products. The LIC model involved engaging deeply with distributors and agents, by educating and equipping them to sell. Agents were well-compensated and penetration was deep. In return, the agents worked exclusively with LIC and did not sell other products.

Unlike this, the mutual fund distribution network evolved in an open architecture mode. All distributors were free to distribute or offer products from multiple asset management companies (AMCs). As a result, the bond between the AMC and the distributor was relatively weaker. An AMC did not end up spending resources beyond a certain level on developing the distributor skills as the latter could then easily use these improved skills to sell other competing products.

The withdrawal of the entry-load, which constituted a good part of the commissions passed on to the distributors, was one of the other factors leading to a sudden change in the distribution space.

Generally, it is more expensive for a distributor to reach out to a retail investor than to a corporate investor. While an average retail investor folio has about 35,000 INR of assets, an average corporate investor folio has 59 lakh 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.

Considering the higher costs of acquisition of a retail investor, one could consider evaluating differential expenses being charged to retail and institutional investors. This may, however, impact investor returns of the two segments who have invested in the same scheme, leading to discontent among retail investors. Moreover, despite the higher upfront cost of acquiring a retail investor, the sticky nature of retail investors indicate that retail consumers break even and are actually more profitable than corporate clients in the long run.

Upfront commission: After the alteration to entry-load norms, in August 2011, transaction charges were introduced to compensate distributors (refer to the ‘transaction charges paid to distributors’ point in the regulatory section). In respect of the ‘opt-in’ facility offered to distributors, only 16% have opted in with the rest opting out of charging the transaction fee. A possible reason for this trend could be the lower limit of 10.000 INR on the ticket size which consequently disincentivises small scale distributors and sub-distributors who typically get large volumes of low ticket size subscriptions. This trend also indicates that this move has only partially brought back distributor interest in selling to this segment.

Trail commission: The changes to trail commission led to large distributors focussing on servicing and retaining existing investor-clients rather than reaching out to new investors. Later, in May 2010, AMFI members agreed to ban trail commission on transferred portfolio.

The reduced trail commission, which was typically charged to schemes, implied increased scheme returns which could prove beneficial to investors. However, the blanket ban on all trail commissions for transferred portfolios could serve as a detraction to investors whose existing agents were not servicing them, given the reduced attraction for a new agent to service sans a trail commission.

The abolition of the entry load and the revision of trail commission guidelines have taken care of some key issues, but in turn have given rise to other aspects which need to be tackled and resolved.

Mandatory disclosure of commission earned: A mandatory disclosure alerts the investor about the extent of distributor gain while putting the onus on the distributor to explain the rationale for the switch.

In this context, a re-introduction of the entry load in its original form appears to many to be a regressive step rather than a solution to the current problems faced by the industry. One of the fallouts of such re-introduction could be an increased churn to some extent.

Payment of distributor commission by investors: Currently, an investor is required to draw two cheques: one to the AMC for the investment amount and the other to the distributor for the commission. Distributors on the field have observed that investors may be hesitant to go through this process. The depositing and subsequent collection of the distribution commissions by the distributor also involves a cost. A system whereby investors are given the option to draw a single cheque to the AMC, which clearly indicates the distribution commission to be paid by the AMC to the distributor, may help in simplifying this process.

Direct channels and exclusive or preferential treatment for distributors: Asset management companies currently do not foresee a significant change in their current cost structure, thereby continuing to have a limited margin to pass on to the distributors as commission. Any increase or decrease in AuM directly affects the revenues (management fees) and profitability of an AMC. In such a scenario, AMCs having access to their 'own' distribution channel to sell mutual fund products have a relative advantage; this includes AMCs with Indian banks and brokerage houses as sponsors. Banks have also been focussing increasingly on earning a higher percentage of their income from services and fees. Hence, there is a mutual benefit for banks to use their network to sell mutual fund products, whether those offered by their own group AMC or by others.

Currently, AMCs not having exclusive distributors have a limited incentive to invest on training and improving the awareness, knowledge and skill of distributors. Economic compulsions could see companies move towards a committed distributorship system.

Alternate lower cost distribution channels: Other avenues for AMCs to diversify their distribution base could include an examination of distribution channels prevalent in other industries, especially those that involve a low distribution cost—such as the FMCG industry. Customers in Tier-2 and lower cities could also be tapped by leveraging on the reach of PSU banks in these areas, which could be mutually beneficial. Alternate technology-based channels including the Internet and mobile banking could also be further explored with the aim of reaching a larger customer base at lower costs.

Given the widespread use of mobile phones and secure payment gateways, it is expected that this channel will be used to directly reach investors for reasons other than merely communicating the daily NAV.

Another suggestion that could be considered is to lighten the AMFI certification requirement for distributors with sales or collection below a certain threshold. This will encourage sub-distributors in the far flung areas to distribute mutual fund products to investors with smaller investible surpluses.

Operational issues and profitability

AMCs are, at times, weighed down by the number of schemes they offer or are under management (in some instances they are more than 200). This may result in a negative impact on the operational efficiency and profitability of the AMCs. The NFO boom that happened a few years ago has left behind a proliferation of schemes, some with overlapping objectives and investments. Yet, each scheme brings with it operational costs driven by regulatory, compliance and risk requirements. Overlapping schemes may be analysed and the possibility of merging overlapping schemes, or discontinuing such schemes or schemes with a less-than-optimal AUM size could be evaluated, subject of course to ensuring that this does not prejudice the interests of investors.

While the SEBI issued a further circular in 2010 stating that a consolidation or merger should not be seen as a change in the fundamental attributes of the surviving schemes if some conditions are met, the absence of an income-tax neutrality and the STT levy are dampeners which should be removed. It may be noted that tax laws do provide for such neutrality to shareholders in case of merger of companies.

Undertaking such an analysis will help AMCs in deciding whether they should merge certain schemes, unwind them or close them. This will, in turn, help the fund management team focus on fewer larger schemes and also reduce regulatory, compliance and risk-related activities.

Another aspect which impacts the operations of the AMCs is the increased level of regulatory disclosure requirements. Over the years, the information and data disclosures required from AMCs and schemes have increased steadily. Operating teams are required to make multiple disclosures at regular intervals, which in turn increase compliance costs.

The related moot question is: does an average investor have the inclination to read and assimilate the flood of information? Should there be an examination of the amount and periodicity of disclosures, and the shape and manner in which it is communicated to investors?

There are restrictions and advisories on the content of advertisements by the AMCs and schemes, and rightly so. While investor protection is essential, there is also the need to find a middle ground to enable effective communication of differentiated returns and the benefits of organised fund management.

While the number of players in the industry has grown in the last five years, the pool of available talent has not kept pace. The demand for experienced quality professionals has often led to compensations that have proved to be difficult to sustain or support in a scenario where margins are already squeezed. The frequent movement of key people also tends to destabilise the teams and operational environment.

Each AMC will need to examine its revenue models and streams. The basic ‘bread and butter’ business of the mutual fund can generate a certain level of revenue and margins. However, it will be useful to explore alternative areas of services that have a meaningful impact on not just the revenue but on profitability as well.

One of these areas which are available is the offering of advisory services to offshore funds. There is a large amount of capital invested in India from overseas; Indian asset managers with a proven track record and necessary infrastructure and network could do well to tap into this segment, which could be a profitability differentiator, with the potential of returning higher margins for the players involved. This in turn would give them greater financial flexibility to invest in targeting untapped investor segments within India.

However, this is not an easy segment to grow as it takes a few key ingredients-a global network, brand and presence, research capabilities, investor connect as well as management resources, time and the financial ability to invest over a long time frame. Other key challenges to this include the tax inefficiencies and uncertainties of managing offshore funds from India. Jurisdictions which seek to promote such a trend and thus aim to become leading financial centres look at prescribing certainty in tax, including at times, ‘safe harbour’ rules which ease the manner of taxation of the income arising out of such activities.

An additional line of business available to AMCs is the management of funds registered under the alternative investment funds (AIFs) regime. These new areas should be explored and business models will need to evolve accordingly.

From a profitability perspective, the picture varies with the total AuM a mutual fund manages and its composition. It is logical to postulate that the longer-term equity-oriented AuM is the more profitable while the shorter debt schemes may offer less sustainable returns to an AMC.

Further, a high AuM may not be a guarantee for high profitability as cost structures do tend to vary with attendant impacts.

Scheme mergers or closures as discussed from the point of view of improved operational efficiencies, will also have an impact on costs. There may also be a case for exploring acquisition or disposal of schemes.

If we look at cost structures within the industry, the salary cost, perhaps, is the single largest block. In a stress scenario, such as the current situation, there may be a need to look at this head of costs on the basis of ‘zero-based budgeting’. Additional compensation structure such as ESOPs could also be explored.

One area where the industry is working together is communications-related expenses. Initiatives such as consolidated statement of holding across schemes, consolidated know your customer (KYC) process will help.

There is also an opportunity to boost online subscriptions. Given the high level of participation by individual investors from the metro and urban areas there is an opportunity to propagate online portfolio management and purchases. While the savings from such a trend may not be initially huge they have the potential to add up in the future.

Product relevance

The theory is that mutual funds cater to certain needs of the investors. Most investors look at products catering to the following needs:

- Protection
- Retirement
- Returns
- Upside

Typically, insurance products such as term plans protect against unplanned or unforeseen eventualities, bank FDs or government or PSU bonds cater to the need for guaranteed, fixed or known returns, pension schemes [the Employee Pension Fund (EPF)] caters to the retirement-related needs, whereas mutual fund instruments are designed to mainly cater to the need for returns and the upside, but have the possibility of being structured to meet other specific needs as well.

The following are some of the aberrations which have occurred in connection with products:

- At times, a lack of thorough analysis of investor needs leads to inappropriate responses in terms of investment recommendations.
- A perception that long-term refers to a period of two to three years as opposed to the more rational view of long-term to mean a period of five to ten years; An overlap among products - it might appear that while the mutual fund investments carry an element of risk the returns are not differentiated enough from, say, the returns offered by bank FDs. There is a lack of clear-cut differentiators between product classes as far as the investor is concerned. The communications by the industry have not seen the desired result in push this point through.
- A commission structure that places mutual fund products at a disadvantage compared with some other products.

The obvious question which arises is how does the mutual fund industry regain and retain the relevance of its products in the mind of the investors as well as the distributors.

There is sufficient evidence to suggest that quite a few schemes have over the long-term delivered a positive alpha; however such 'successes' are not uniform. The fact that this reflects a relative performance as opposed to an absolute performance needs to be communicated to the investors appropriately.

There are opportunities even within the new norms for distributing compensation relating to trail commission and the manner of payment which can be utilised to optimise mutual benefit.

Creation of a 'level playing field' among the various financial products is an area which needs to be looked into.

One question that needs to be addressed is whether product commoditisation is the way to go as investors may only be interested in a few simple routes to invest in the stock markets. An analysis of emerging investment trends may to have a story to tell. Systematic investment plans (SIPs) are emerging rapidly in new geographical markets as they represent a method of 'regular savings' and are easily understood. They also attract investors with long-term commitments.

The vanilla large cap products garner maximum investments as most of the institutional investors such as MFs, insurance, etc. invest in the top 150 stocks.

Therefore, is there a case for the re-emergence of the exchange-traded fund (ETF) – including gold ETF products - products? Many investors understand the indices and this gives them an opportunity to invest prudently.

Opportunities

In any industry, innovation and improvements happen when the rules are changed. Large-scale environmental changes such as those that have taken place in the last three years must lead to innovation and evolution.

- *Newer leaner operating structures will have to evolve which will entail the use of technology that helps an AMC reach the retail end user with solutions that enable transactions via platforms such as mobile or online platforms.*

  This will not only give greater direct access but will also help AMCs to better understand investor behaviour and create the appropriate environment and products to move towards long and healthy relationships with the investors.
- *As the industry evolves, outsourcing an increasing number of functions to reduce the head-count and increase efficiency might be the norm. All aspects of operating costs must be examined for efficiencies.*
- *A rational look at schemes of an AMC by their management teams is needed to better understand the mix, the cost and the benefits – to the investors as well as to the AMCs.*
- *Agile product design, re-positioning of ETFs and SIPs*
- *Better communication of scheme returns on a relative basis to investors is required. The alpha achieved is insufficiently communicated or understood.*
- *The new AIF guidelines will create opportunities to broaden the revenue base without commensurate cost increases.*
- *The asset management industries in the US and in Japan have had their "401 k" moments. In the late 70s market regulators in the US permitted pension funds (later 401K) to invest a portion of their funds (at the discretion of the individual) into mutual fund schemes. This saw a huge upsurge in the AuM of the industry as a whole.*

  Similarly the Japanese asset management industry went on a growth surge around the turn of the century when the pension and retirement funds were permitted to be invested in the asset management schemes.

  The EPF in India is a huge pool of long-term investible funds. These are expected to yield high returns. If the right mechanism were to be created to channelise even a small proportion of the funds to be invested in the Indian mutual fund schemes (specific schemes can be selected if required), it will provide a boost to the industry, apart from maintaining the more important objective of having the funds managed by a regulated sector and by persons with a track record. Imagine the change if 20% of the 3,00,000 crore INR were permitted to be invested in the Indian capital markets via the asset management industry. It will be the industry's '401K' moment.

  A similar impact could be generated by introducing the concept of individual retirement accounts (IRAs). Some of the investment products available are in the nature of retirement benefit plans (EPF, PPF and now NPS as well as certain insurance products). Avenues such as EPF are available to only a certain section of the population. To encourage people to save for the post retirement period IRAs can be offered.

  The investments into such schemes could be self-directed, flexible and in specific circumstances tax deductible. The fund so created could be available tax free (EEE) at the age of retirement.

Such a concept exists in the mature western markets such as the US and contributes to about 20% of the assets under management!

- *The recently announced Rajiv Gandhi Equity Savings Scheme is another opportunity for the mutual fund industry. We believe that given the low financial awareness of such new or first time investors in the far flung regions, it is imperative that these investors are channelised into the markets via mutual funds rather than directly investing into equities themselves!*
- *Advisory services to off-shore funds should be explored further as an area of revenue diversification. More could be done in this direction.*

Views from across the globe

PwC conducts an annual survey of CEOs across 14 countries with significant financial markets. Following are the key views from the asset management section of the PwC's 15th Annual Global CEO Survey:

- Over 90% of the CEOs polled are confident of revenue growth over the next three years despite extreme concerns regarding the economic growth and capital market stability.
- Over 50% said that they will need to tweak or alter their strategies in the changed and changing economic environment, while very few believed there is a need for radical strategic changes.
- Keeping in mind the future outlook, 66% are looking at cost reduction initiatives, 40% will explore outsourcing opportunities, 30% will explore cross-border merger and acquisition (M&A) and 50% will explore a strategic alliance or a joint venture.
- Nearly 67% were concerned about the level of regulation.
- Between 50 to 70% said they anticipate changes in the following:
    - Approach to risk management
    - Strategies for talent management
    - Organisational structure (including M&A)
    - Investment decisions
    - Technology investments
    - Capacity creation for innovation and R&D
- Around 65% said that they will personally be involved in developing leadership and talent. High potential middle managerial staff is seen to be the area of greatest challenge with respect to recruitment and retention.

Some of the key thoughts of Indian mutual funds CEOs are as follows:

- The overall cap on expenses chargeable to a scheme can continue but individual AMCs could then decide on the allocation inter-se among various cost heads. Also, the service tax on the advisory fee is a part of the overall cap. This could be over and above the capped costs.
- A case can be made for allowing AMCs to charge differential expenses to a retail investor and a large corporate investor.
- A portion of some of the available long-term savings such as the provident fund pool can be channelised into in mutual fund schemes. Also investments under the proposed RGESS can also be channelised to mutual funds.
- The alternative investment fund (AIF) guidelines enable the industry to explore options to develop expertise and offerings to broaden revenue sources.
- The industry needs to effectively manage perception and experience of investors. Improved services and communication will be mutually beneficial.
- There is also a need to simplify the product and its distribution to gain higher acceptability, reach and penetration.

Regulatory trends:
Alignment of industry and investor goals

Some of the key changes in the past year include the following:

Qualified Foreign Investors' (QFI) regime

Investment in mutual fund[1]

Earlier, only foreign institutional investor and non-resident Indians were permitted to invest in mutual fund schemes. Direct access to foreign investors was not permitted. The Securities and Exchange Board of India (SEBI) and the Reserve Bank of India (RBI) issued circulars to facilitate direct investment by QFIs in mutual fund schemes. The salient features of the QFI regime are as follows:

- QFI shall mean a person who is a - resident in a country that is a member of Financial Action Task Force (FATF) or a member of a group which is a member of FATF. Accordingly, residents of countries of the Gulf Cooperation Council and European Commission would be eligible to invest under the QFI regime. Further, the QFI should be a resident in a country that is a signatory to the International Organisation of Securities Commission's Multilateral Memorandum of Understanding (MOU) or a signatory of a bilateral MOU with the SEBI.
- QFIs need to meet KYC requirements as per the FATF standards, Prevention of Money Laundering Act, 2002 and rules and regulations made under the SEBI circulars.
- The definitions of the terms 'person' and 'resident in India' have been linked to the definitions of the respective terms under the Foreign Exchange Management Act (FEMA) and Income-tax Act, 1961.
- QFIs can invest in rupee denominated units of equity schemes and infrastructure debt schemes of mutual funds. The overall investment limits for QFIs is 10 billion USD for equity schemes and 3 billion USD for infrastructure debt schemes. However, subscriptions can be accepted by the mutual funds only up to 8 billion USD and 2.5 billion USD for equity and infrastructure debt schemes respectively. The balance limits will be auctioned by the SEBI through the bidding process.
- In case a person invests in the same company through both the QFI and FDI route, the aggregate holding of the person in such company shall not exceed 5% of paid up equity capital of the company at any point of time.
- QFIs may invest under either the direct route where the investment is routed through its single non-interest bearing rupee account with an AD category- I bank in India or through the indirect route, where the investment is routed through an issuer issuing Unit Confirmation Receipts (UCRs). In this route, a mutual fund would be permitted to open foreign currency accounts outside India for the limited purposes of receiving subscriptions from the QFIs as well as for redeeming the UCRs collecting or redeeming subscriptions from the QFIs.
- The QFIs may appoint a custodian of securities, who will be obligated to perform clearing and settlement of securities on behalf of the QFI client.

The QFI regime was announced to provide impetus to capital markets and it is yet to see full results. Aspects requiring consideration include the following:

- Restrictions or licencing requirements in off-shore jurisdictions for distribution of products of Indian mutual funds
- Indian taxation regime requiring overseas investors to seek registration with revenue authorities and file tax returns

Investment in equity shares and corporate bonds[2]

The central government has decided to allow QFIs to directly invest in Indian equity market in order to widen the class of investors, attract more foreign funds, reduce market volatility and to deepen the country's capital market. The SEBI and the RBI have issued circulars to facilitate such investments. Further, in Budget 2012-13 speech, the Finance Minister has proposed to allow QFIs to access the Corporate Bond market. In this connection, a separate sub-limit of 1 billion USD has been created for QFIs investment in corporate bonds and mutual fund debt schemes.

1 AP (DIR series) circular no08 dated 9 August 2011; circular no CIR/IMD/DF/14/2011 dated 9 August 2011 and circular no CIR/IMD/FII&C/13/2012 dated 7 June 2012..

Common fund managers[3]

To address the issue of conflict of interest wherein a fund manager manages schemes of mutual fund and is engaged in other permissible activities of the AMC, the SEBI has amended the mutual fund regulation. AMCs shall now appoint a separate fund manager for each fund managed by it unless the investment objectives and assets allocations are the same and the portfolio is replicated across all the funds managed by the fund manager. Further, since perfect replication of portfolios may not be achieved at all times, a replication of minimum 70% of portfolio value shall be considered as adequate for the purpose of said compliance provided the AMC ensures at all points of time that the fund manager shall not take directionally opposite positions in the schemes managed.

The AMC will have to disclose on its website the returns on all its schemes managed by the fund manager. Further, in case the difference between the annual returns provided by the schemes managed by the same fund manager is more than 10% then the same shall be reported to the trustee and its explanation shall be disclosed on the website of the AMC.

Business activities of the AMC[4]

For this, the SEBI has permitted that an AMC may, itself or through its subsidiaries, undertake portfolio management services and advisory services for other than broad-based funds (fund which has at least 20 investors and no single investor accounts for more than 25% of the corpus of the fund), subject to compliance with certain prescribed conditions.

Further, it has been laid down that an AMC shall not carry out any part of its activities including trading desk, unit holder servicing and investment operations outside India.

Transaction charges paid to distributors[5]

The SEBI has permitted distributors of mutual fund products to recover transaction charges of 100 INR for existing investors and 150 INR for new investors per subscription of 10,000 INR and above. The transaction charges shall be deducted by the AMC from the subscription amount and paid to the distributor; and the balance amount shall be invested. Further, distributors shall be able to choose to 'opt-out' of charging the transaction charge provided the same is done at distributor level and not investor level i.e., a distributor shall not charge one investor and choose not to charge another investor. In case of SIPs, the transaction charges may be recovered in three to four instalments. Further, mutual funds shall institute systems to detect if a distributor is splitting investments to enhance the amount of transaction charges and take stringent action including recommendation to the AMFI to take appropriate action.

Distributor due diligence[6]

It was felt that in the interest of investors there was a need to regulate the distributors through AMCs by putting in place a due diligence process to be conducted by them. The SEBI directed AMCs to carry out a due diligence for distributors satisfying one of the following criteria:

- Multiple point presence (more than 20 locations)
- AuM raised over 1,000 million INR across industry in non-institutional category but including high net worth individuals
- Commission received of over 10 million INR pa across industry
- Commission received of over 5 million INR from a single mutual fund

At the time of empanelling distributors, mutual funds and AMCs shall undertake due diligence to satisfy 'fit and proper' criteria. Further, the SEBI has clarified that the due diligence of distributors is solely the responsibility of mutual funds and AMCs. This responsibility shall not be delegated to any agency. However, mutual funds and AMCs may take assistance of a reputed agency while carrying out due diligence process of distributors.

Participation in repo in corporate debt securities[7]

The SEBI, vide a circular, has enabled mutual funds to participate in repos in corporate debt subject to approval, as per the guidelines issued by the RBI from time-to-time and subject to certain conditions.

2 A P (DIR series) circular no66 dated 13 January 2012; circular no CIR/ IMD/FII&C/3/2012 dated 13 January 2012 and press release F no 10/1/2011-ECB dated 29 May 2012;
3 Circular no. Cir/IMD/DF/7/2012 dated 28 February 2012
4 SEBI (Mutual Funds) (Amendment) Regulations, 2011 vide Notification dated 30 August 2011
5 Circular no. Cir/IMD/DF/13/2011 dated 22 August 2011
6 Circular No. Cir/IMD/DF/13/2011 dated August 22, 2011 and Circular No. Cir/IMD/DF/7/2012 dated February 28, 2012
7 Circular No. CIR/IMD/DF/19/2011 dated November 11, 2011

Portfolio Managers' Regulations[8]

Certain amendments to the SEBI (Portfolio Managers) Regulations are relevant for the mutual fund industry. These include the following Certain amendments to the SEBI (Portfolio Managers) Regulations are relevant for the mutual fund industry. These include the following:

- An increase in the minimum investment amount per client from 0.5 million INR to 2.5 million INR. The enhanced minimum investment amount shall be applicable for new clients and fresh investments by existing clients. The existing investments of the clients will continue as such till the maturity of the investment.
- The portfolio manager shall not hold unlisted securities, belonging to a client, in its own name on behalf of its client, either by virtue of a contract with the client or otherwise. The portfolio manager will have to segregate each client's holding in unlisted securities in a separate account in respect of investment by new clients and fresh investments by existing clients. The existing investments in unlisted securities of clients, as on the date of notification may continue as such till maturity of the investment.

Infrastructure debt fund (IDF) scheme[9]

The framework for setting up infrastructure debt funds as a sub-set of mutual funds was announced. The salient features of the IDF scheme are as follows:

- IDFs can be set up by any existing mutual fund. Additionally, companies which have been engaged in infrastructure financing and which fulfil certain eligibility criteria can set up mutual funds exclusively for launching IDF schemes.
- IDFs are required to invest at least 90% of their assets in debt securities or securitised debt instrument of infrastructure companies or infrastructure capital companies or infrastructure projects or SPVs which are created for the purpose of facilitating or promoting investment in infrastructure, bank loans in respect of completed and revenue generating projects of infrastructure companies, etc.
- The minimum investment in IDF should be at least 10 million INR with a unit size of at least 1 million INR. The schemes should have a firm commitment to the extent of 250 million INR from strategic investors.
- IDFs should have minimum five investors, with no single investor holding more than 50% of the net assets.
- IDF scheme can be launched either as a close-ended scheme maturing after five years or as an interval scheme with a lock-in of five years

Tax incentive for investments in stock markets

During the Budget 2012-13 speech, the finance minister indicated introducing of a new equity savings scheme to encourage savings in financial instruments and improve the depth of capital market. The Finance Act provides deduction in the hands of a resident individual on investment in specified listed equity shares subject to satisfaction of certain conditions. The maximum deduction limit is 25,000 INR per year.

The Direct Taxes Code (DTC)

The tax proposals in the DTC were expected to change the manner of taxation of returns offered by the mutual fund industry, particularly the income distribution. While, the DTC has been deferred, as indicated by the Finance Minister in his Budget 2012-13 speech, necessary steps will be taken for the enactment of the DTC at the earliest.

8 SEBi (Portfolio Managers) (Amendment) Regulations, 2012 vide Notification dated February 10, 2012
9 SEBI (Mutual Funds) (Amendment) Regulations, 2011 vide notification dated 30 August 2011
10 SEBI (Alternative Investment Funds) Regulations, 2012 vide notification dated 21 May 2012.

Role of self-regulatory organisation (SRO) and independent financial advisors

The SEBI released a concept paper on regulation of investment advisors for public comments. The definition of investment advisor for the purpose of the regulation shall be any person or entity that provides investment advice directly or indirectly for a consideration, which may be received directly from the investor or who holds himself out as an investment advisor.

Some of the salient features of the proposed regulation are as follows:

- For registration certain eligibility criteria have been specified. The concept paper clarifies that portfolio managers who provide only investment advice would need to be registered only as an investment advisor on expiry of their present registration.
- Certain categories are exempted from registration under the regulations such as stock brokers or sub-brokers registered with the SEBI providing investment advice without a consideration, person offering exclusively insurance broking services, etc.
- The regulation also lays down various obligations for the investment advisor such as maintaining client confidentiality, maintenance of records of the client's risk profiling. non-acceptance of any financial incentives or consideration from any person other than the investor, keeping records in support of every investment recommendation or transaction for at least five years, appropriate disclosure about the optional executive services, etc.

Role of SRO

- The paper provides regulation for investment advisors through a SRO registered under the SEBI (SRO) Regulations, 2004.
- Persons desirous of registration as investment advisors shall obtain registration with the SRO established for this purpose.
- The duties of SRO would include registering and setting minimum professional standards, including certification of investment advisors, laying down rules and regulations and enforcing those informing and educating the investing public, setting up and administering a disputes resolution forum for investors and registered entities, etc.
- The SRO will be entitled to charge a fee for granting registration and an annual fee.
- Complaints or disputes arising out of investment advisory services will be taken up by the SRO with the respective regulatory authority, while the complaints regarding the financial products and their manufacturers will be handled by the respective regulators.

International updates

Regulatory updates in the European Union (EU)

The Alternative Investment Fund Managers Directive (AIFMD)

The AIFMD is a European directive aimed at providing a harmonised regulatory and supervisory framework for managers of Alternative Investment Funds within the EU. It sets out rules regarding the organisation and business of the managers, imposes certain new requirements on the AIFs and allows their marketing to professional investors via a passport throughout EU. The ultimate deadline for the EU member states to transpose the AIFMD into their national law is July 2013.

The Undertakings for Collective Investments in Transferable Securities (UCITS V)

The European Commission (EC) is currently consulting on proposed changes to the role of UCITS depositaries and the remuneration of UCITS managers, to address perceived failings, better protect investors and align UCITS funds with the measures instituted for alternative investment funds under the Alternative Investment Fund Managers Directive (AIFMD). The depositary role would be strengthened by expanding its oversight responsibilities, increasing its liability and shifting the burden of proof onto the depositary for negligence or intentional failure to perform its duties. The remuneration measures proposed largely follow the trend seen in the banking industry and under AIFMD, seeking to more closely align the interests of financial services industry players to those of investors. These changes have significant implications for UCITS managers, depositaries, third party administrators, investor, auditors, and regulators.

Regulatory updates in the UK

Tax transparent collective investment schemes to be introduced

- Her Majesty's Treasury is making the country more competitive with popular fund domiciles such as Dublin and Luxembourg with its consultation on contractual schemes for collective investment published in January 2012. The consultation introduces a new type of authorised fund that can be launched in the UK, a tax transparent fund.
- A further consultation followed from the Financial Services Authority (FSA) in March 2012 to set out its draft rules to be implemented into the FSA handbook. It is expected that the tax transparent fund regime would be formally implemented in the UK by the summer of 2012.

Retail distribution review

- The FSA launched its retail distribution review (RDR) due to come into force on 1 January 2013. The review targets the quality and standard of advice available to consumers in the financial services sector. This will be live on 31 December 2012. Further rules follow from the FSA throughout 2011 and 2012 to provide firms with more clarity on the expectations of the FSA. The RDR bans the payment of commission from fund managers to financial advisers for providing advice to retail investors.

Regulatory updates in the US

Foreign Account Tax Compliance Act (FATCA) update

FATCA's statutory provisions were intentionally broad and gave considerable discretion to the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) to narrow its scope in the implementing regulations. Notice 2010-60, released in August 2010, provided the first directional thinking on how the provisions of FATCA would operate. Treasury and the IRS subsequently issued two additional Notices (collectively they are referred to as the 'Notices') that provided additional guidance on how FATCA's provisions would operate.

On 8 February 2012, Treasury and the IRS issued proposed regulations that provide details on many of the principles introduced in the Notices. Simultaneous with the issuance of the proposed regulations, the governments of the United States, France, Germany, Italy, Spain, and the United Kingdom released a joint statement explaining that they are exploring a common approach to FATCA implementation through domestic reporting and automatic information exchange systems. The statement also emphasises the willingness of the United States to reciprocate by automatically collecting and exchanging information on accounts held in the country's financial institutions by residents of the respective countries.

The proposed regulations also incorporate some of the ideas and suggestions received from various stakeholders. The regulations also include several provisions that were not included in the Notices.

Conclusion: Evolution and not revolution

The Indian asset management industry has answered existential questions. However, the present scenario demands vigorous innovation and reinvention. Wholesale or drastic changes may not be warranted; instead, the purpose may be better served by adopting a cluster of key initiatives in the areas of cost efficiency, product design and positioning, alternative distribution models, revenue diversification and capacity creation. We believe a sensitive regulatory environment will support the evolution going forward.

Mutual fund products are a natural component of options for all class of investors and will remain so. The evolution is more towards gaining a larger mindshare with all key stakeholders including, most importantly, the investors.

About CII

The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the growth of industry in India, partnering industry and government alike through advisory and consultative processes.

CII is a non-government, not-for-profit, industry led and industry managed organisation, playing a proactive role in India's development process. Founded over 117 years ago, it is India's premier business association, with a direct membership of over 7100 organisations from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 90,000 companies from around 250 national and regional sectoral associations.

CII catalyses change by working closely with government on policy issues, enhancing efficiency, competitiveness and expanding business opportunities for industry through a range of specialised services and global linkages. It also provides a platform for sectoral consensus building and networking. Major emphasis is laid on projecting a positive image of business, assisting industry to identify and execute corporate citizenship programmes. Partnerships with over 120 NGOs across the country carry forward our initiatives in integrated and inclusive development, which include health, education, livelihood, diversity management, skill development and water, to name a few.

The CII Theme for 2012-13, 'Reviving Economic Growth: Reforms and Governance,' accords top priority to restoring the growth trajectory of the nation, while building Global Competitiveness, Inclusivity and Sustainability. Towards this, CII advocacy will focus on structural reforms, both at the Centre and in the States, and effective governance, while taking efforts and initiatives in Affirmative Action, Skill Development, and International Engagement to the next level.

With 63 offices including 10 Centres of Excellence in India, and 7 overseas offices in Australia, China, France, Singapore, South Africa, UK, and USA, as well as institutional partnerships with 223 counterpart organisations in 90 countries, CII serves as a reference point for Indian industry and the international business community.

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