CII 6th Mutual Fund Summit 2010

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Indian Mutual Fund Industry - Towards 2015

Sustaining Inclusive Growth - Evolving Business Models

PricewaterhouseCoopers


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Chairman's Message

The Indian mutual fund industry is passing through a transformation. On one side it has seen a number of regulatory developments while on the other the overall economy is just recovering from the global crisis of 2008. The regulatory changes have been made keeping in mind the best interests of the investors. However, like all changes these changes will take time to be adapted by industry, intermediaries and the investing public at large. The industry is looking forward to early resolution of certain inter-regulatory issues requiring Government / Court intervention. Market participants are waiting to see how the industry adapts to these changes, while trying to maintain its pace of growth. Mutual funds are restructuring their business models to provide for increased efficiencies and investor satisfaction. The industry also faces a number of issues which are characterized by lack of investor awareness, low penetration levels, high dependence on corporate sector and spiraling cost of operations. The Growth rate of the industry therefore needs to be seen from this perspective. Though, it is commendable to note, that, Assets Under Management have managed to record a compounded growth of 28% over 2006-2010, however, the AUM of Equity Funds and Balanced Funds where retail investors invest have only grown by 20% in the same period. The net sales of Equity/Balanced funds in 2009-10 have been one of the lowest in recent years.

India has vast growth potential backed by a resilient economy, commensurate with an accelerated GDP growth rate of 7.4%, high rate of household savings and investments. This report by PwC seeks to outline the current state of the industry, with its growth drivers and continuing challenges. It also seeks to draw a comparison with other global economies, the business and regulatory trends which have been impacting this industry with a snapshot of some of the regulatory changes anticipated around the corner.

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.

U K Sinha

Chairman - CII National Committee on Mutual Funds
Chairman - CII Mutual Fund Summit 2010
Chairman & Managing Director, UTI Asset Management Company Limited

Foreword

Mutual funds as an investment vehicle have gained immense popularity in the current scenario, which is clearly reflected in the robust growth levels of assets under management. However, despite this growth, penetration levels in India are low as compared to other global economies. Assets under management as a percentage of GDP is less than 5 per cent in India as compared to 70 per cent in the US, 61 per cent in France and 37 per cent in Brazil. Through this report, we have tried to assess the key growth drivers for the industry, identifying in the process the factors which may impede growth in the future. The evolving business and regulatory trends in India have also been discussed, drawing a comparison with similar developments across other global economies.

To support our analysis, we have also conducted a few interviews with CEOs of local asset management companies to help us understand better, the challenges faced by the industry.

We hope that you find this report insightful and supportive of further discussions and action. We welcome comments and observations from the readers of this report to enable us to incorporate any valuable suggestions in the next report.

Jairaj Purandare

Executive Director & Leader - Financial Services
PricewaterhouseCoopers India

Gautam Mehra

Executive Director & Leader - Asset Management
PricewaterhouseCoopers India

01 Background and Objectives

India is undoubtedly emerging as the next big investment destination, riding on a high savings and investment rate, as compared to other Asian economies. As per a report authored by PwC "The World in 2050", the average real GDP growth in India was likely to be in the range of 5.8% between 2007-50, (the actual average GDP growth between 2007-10 has been 7.6%) with per capita income rising to USD 20,000 from the current USD 2,932. Over 50 per cent of the population is less than 25 years of age, with the proportion of working population likely to increase significantly over the next decade. The trend of rising personal incomes has been witnessed not only amongst the young population, but also the high net worth (HNI) segment, which have sizeable sums to invest. One estimate indicates that there are more than 120,000 dollar millionaires in India and the number is increasing. The house-hold segment therefore proffers immense scope for attracting investments. India has a strong middle class of 250-300 million, which is expected to double over the next two decades.

It is in the backdrop of some of these encouraging statistics that the Indian mutual fund industry has fostered itself. Since the 1990's when the mutual fund space opened up to the private sector, the industry has traversed a long path, adapting itself continuously, to the changes that have come along. Growth in Assets Under Management (AUM) experienced has been unprecedented, growing at a CAGR of 28% over the last four years, slowing down only over the last two years, as a fallout of the global economic slowdown and financial crisis. Although investor confidence was significantly eroded and AUMs suffered a dent, the sale of mutual funds has revived over the last few quarters, which implies regained confidence of investors, striving to look at alternate investment opportunities and any attendant higher returns, though the markets continue to be choppy.

In today's volatile market environment, mutual funds are looked upon as a transparent and low cost investment vehicle, which attracts a fair share of investor attention helping spur the growth of the industry. Over time, inclusive growth across the financial sector, seems to have taken centre-stage, re-designing all business strategies around this sole objective. The mutual fund industry being no exception, various measures are being taken by fund houses and distributors to spread access and reach to the semi-urban and rural segments. Clearly, the role of technology as a growth enabler has assumed enhanced responsibility in this respect, to enable improved reach, inclined towards efficient distribution.

The landscape of the financial sector in India is continuously evolving, accredited to regulatory changes being undertaken, which is leading market participants like the asset management companies (AMCs) and distributors to restructure their strategies and adopt business models which will yield sustainable benefits.

Some of the other trends which have emerged strongly over the past year are heavy outflows triggered by market volatility and partnering of asset management companies with banks, to increase the strength of distribution networks.

It is worthwhile at this point to take note of some of the business and regulatory trends taking shape across the global economies, which might cast a shadow on the Indian markets. Developments on aspects of entry load, management fees paid to asset management companies, regulation of distributors and taxation of mutual funds from the investor point of view, are some of the areas which deserve to be given attention.

The road ahead for the mutual fund industry will be paved by the performance of the capital markets. But, more importantly, it remains to be seen, how fund houses adapt themselves to changes in regulations, thereby shaping growth for the future. A continuously evolving regulatory framework makes it mandatory for the industry to elicit a clear growth path, making it easier to assess obstacles and tide over them with time. It remains to be seen, how the industry progresses towards achieving its growth vision for 2015.

High growth story envisaged for the mutual fund industry in 2015

Last year the summit ended on the note of a vision for 2015, stating a positive outlook for assets under management growing at 15%-25%, between 2010 and 2015, the pace of growth being matched by the GDP growth rate of the economy. Profitability of the industry though, may decline substantially, as a fall out of spiraling operating costs and lower revenues.

Higher penetration levels were also estimated riding on the back of the accelerated drive for investor awareness, increase in investible surplus and a younger population with the capacity to absorb higher risks (of market movements in NAVs). In addition, regulatory environment was expected to take a turn, towards an alignment of financial regulations across the financial services sector.

Where do we stand in 2010?

The Indian mutual fund industry is undergoing a metamorphosis, which inadvertently marks a point of inflection for the market participants. However, even amidst volatile market conditions, average assets under management indicated vibrant growth levels posting a y-o-y growth of 47% in 2009-10, and the total AUM stood at Rs 613,979 crore, as of March 31, 2010. Aggregate funds mobilized during the year also grew 84%, supplemented by around 174 new schemes launched during April 2009 to March 2010. The investor base has also steadily expanded and between November 2009 to March 2010, there was an addition of 60,834 investors.

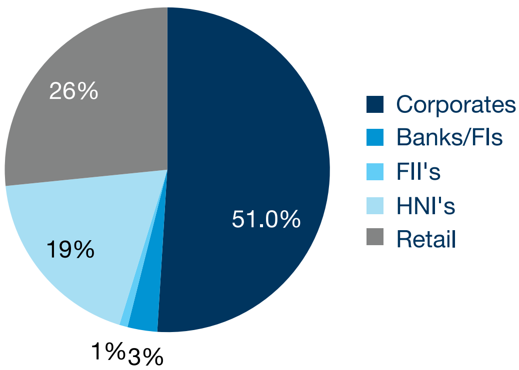
These statistics testify, that the Indian mutual fund industry has weathered the financial crisis, but it cannot be denied that the industry still continues to deal with challenges of low retail participation and penetration levels.

Investor contribution remains skewed towards the corporate sector…

Inspite of India offering an exciting retail environment, with abundant growth opportunities, participation from the segment of retail investors continues to remain at deplorably low levels. As of March 31, 2010, the participation from the retail segment was 26.6%, a marginal increase from 21.3% as on March 31, 2009.

Dependence on the corporate sector is still pretty pronounced at 51%, which is not much of a change from last year. Volatile market conditions, sound a note of caution for the industry, as high dependence on the corporate sector may result in the fund houses being prone to unexpected redemption pressures.

Investor Contribution as of March 31, 2010

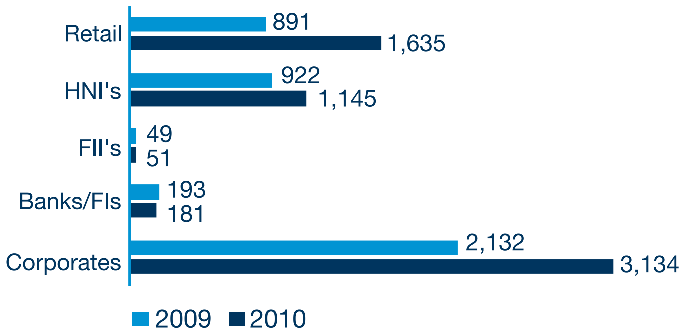


Source: AMFI

The rationale behind institutional sales claiming such a large chunk of the AUM pie is the benefit of tax arbitrage and lack of short term investment options. When compared with economies like US and China, investments channelized through corporates, comprise only around 15% and 30% of the assets under management (AUM), respectively.

Overall, the assets under management recorded an impressive growth of 47%, as of March 2010 which was predominantly driven by the corporate sector, posting the same level of growth. In the same period, the retail sector also managed to report a strong growth of 84% in its assets under management, followed by the HNI segment growing 24%. It has been observed of late, that the HNI segment especially in Tier 2 &Tier 3 cities has expanded creating a pool of investible surplus at the disposal of the mutual fund industry.

AUM under the various segments (In Rs Billion)

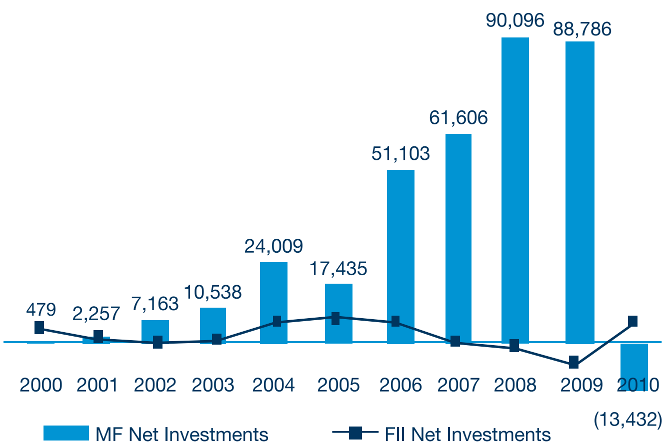


Source: AMFI

…with Equity participation lagging behind market expectations

Historically, it has been observed that an equity fund remains locked in for an average of 18 months. As per AMFI statistics, around 40 per cent of retail investors exit from equity funds before they complete two years. Even in the HNI segment, only 48 per cent investors remain invested in equity funds for over two years. Growth in the equity base has been particularly sluggish in the past year, burdened with huge outflow of funds. Mutual fund net investments in equity have plummeted sharply over the last year from Rs 6,983 crores in March 2009 to an outflow of Rs 4,082 crores in March 2010. At this point, it is interesting to make note of the movement of FII investments plotted against net mutual fund investments over the last decade.

Mutual Fund Investments Vs FII Investments (In Rs Crores)



Source: SEBI

FII investments indicated a steady growth between 2003-05, declining in the period between 2006-09 and then registering a slight recovery in 2010. Growth in FII investments post 2009 would indicate that India continues to be an attractive investment destination, borne out by such empirical facts.

Fund houses seem to have realized the potential of the offshore segment

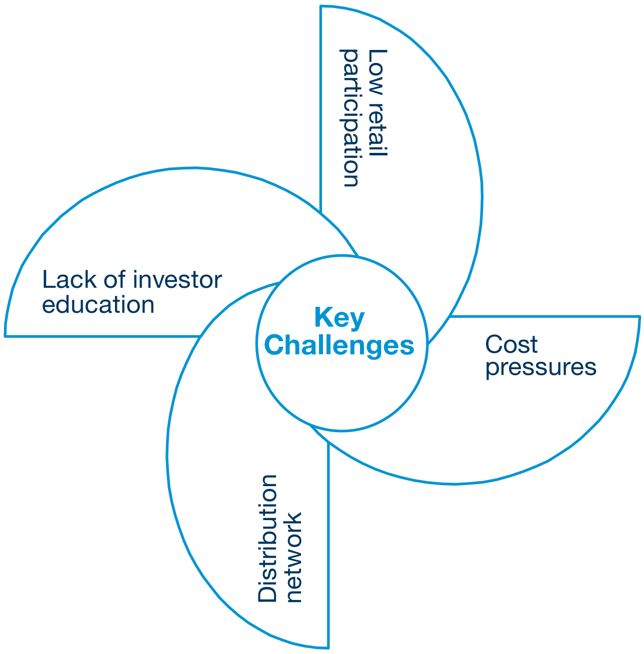
In the past, Fund houses have not given enough emphasis to the offshore segment, which is seen as an opportunity to increase the scale of business, capitalizing upon the fact that India is an attractive investment destination. This is specifically targeted at foreign institutions, pension and endowment funds, along with HNI clients and non-resident Indians, who want to invest in the Indian market.

Roping in a foreign partner can help propel distribution avenues thereby also bringing to the forefront new prospects for fresh entrants. New players may tap this segment and find it as a viable option.

Challenges which continue to persist are …

There are continuing concerns that the industry has been grappling with over a considerable period of time.

- Under-penetrated population
- Inaccessibility in smaller towns and cities due to lack of an efficient distribution network
- Heavy reliance on institutional sales
- Low financial literacy levels and
- Cost pressures emanating as a result of inefficiencies in systems and processes



The industry should start taking appropriate measures to deal with these challenges, so that growth is not hampered in any way, and the sector is free to scale greater heights, and achieve greater penetration.

02 Tectonic changes in Business Models have been necessitated to sustain profitability …

The restriction of entry load on existing and new mutual funds last year marked a turning point in the functioning of the mutual fund industry. This in effect, has spelt out a huge impact on the commission structure of distributors, leading fund houses and distributors to restructure their business and operating models in order to arrive at a profitable solution. The way the distributor community is reacting is manifold:

1. Repositioning as Financial advisors
2. Efficient Online Investment management
3. Selling high margin products to new clients acquired

Source: PwC Analysis

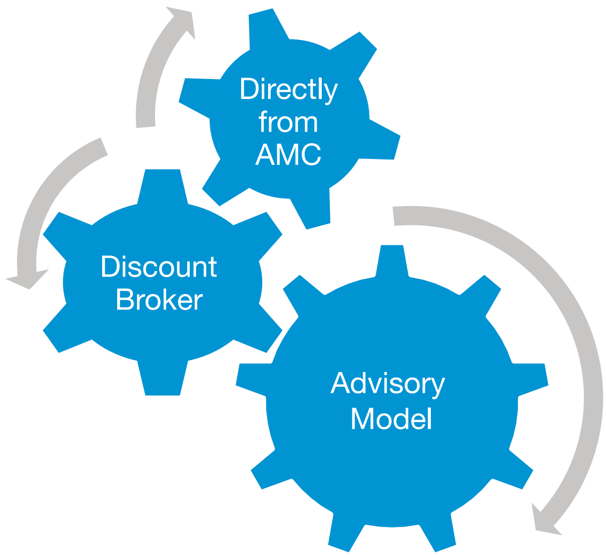
Intermediation has become painful for distributors who are making the best of this current situation by turning themselves into financial advisors, which would act as a positive step towards financial literacy of investors. Another measure which is being adopted by distributors is that of deeper segmentation of clients, wherein the lower rung of revenue earners is being encouraged to transact online. In addition, retail strategies are being modified to generate optimum efficiencies. There is also another category of distributors which is using this regulatory change as a stepping stone to acquiring new clientele by luring them with attractive mutual funds and then selling them high margin products.

Industry speak:

- It is difficult to strategise a new business model in the current situation; it will entail higher costs
- Partnering with banks may be a possible solution to improve distribution, but banks lack the expertise to offer investment advice
- It is advisable to explore open architecture platforms or aggregator models for conducting business
- It may help to have a guideline akin to that of priority sector lending to provide continued push under financial inclusion
- The market should be given enough time to respond and adapt to changes in regulation ; such changes should be in stages

The various options for Business models that are currently being explored are:

- Discount Brokers - They will serve customers at a nominal fee, earning commissions from the AMC in addition to receiving trail commissions
- Directly from AMC - This model is apt if the customer is able to identify the type of fund that he wants to invest in.
- Advisory Model - This model functions on fees paid to financial advisors for advice rendered by them. Liaison with an advisory model is more likely to pave the way for long term benefits, aiding in gaining more market share.



However, distributors seem to be daunted by a common concern of lack of adequate investor education, impacting all these models, as their success will depend extensively on the levels of financial literacy among investors.

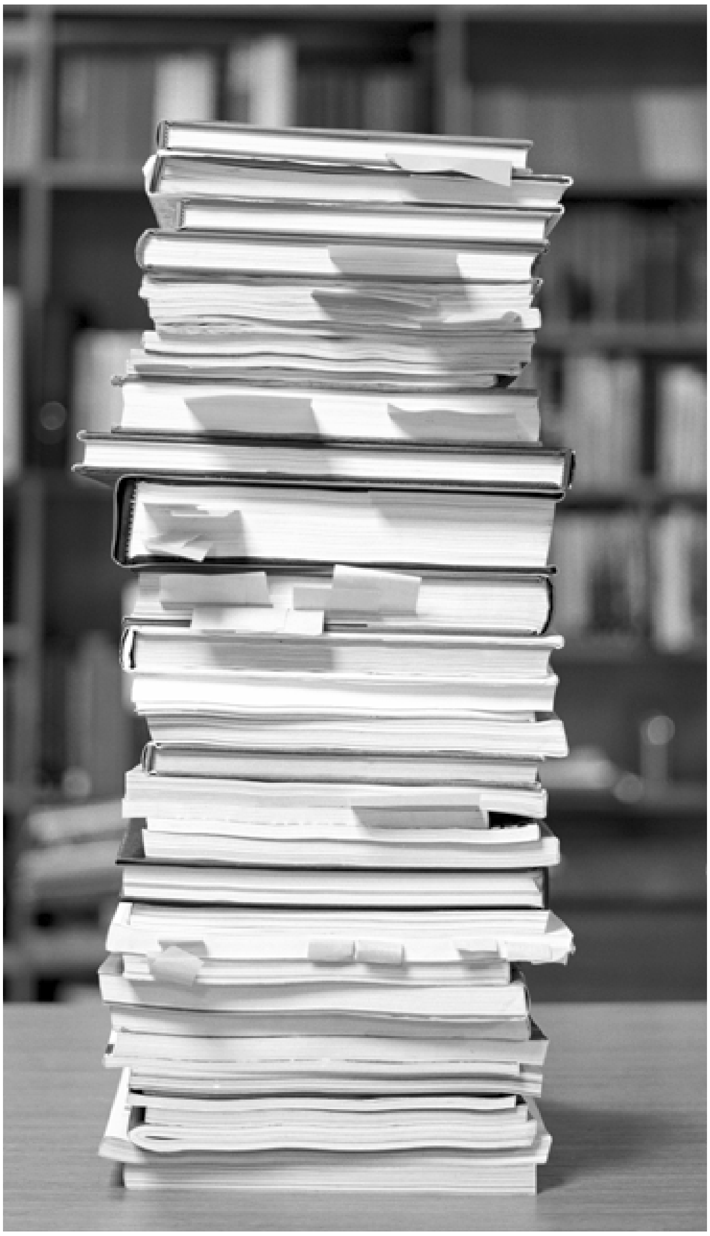
CEO Speak:

- Out of the box thinking required for distribution models, interesting learnings involved from FMCG's, Banks etc, where large volumes of retail clients are serviced, with a reach, deep into rural areas...

All roads lead to increased investor awareness…

In the midst of this entire ambit of distribution, the investor undoubtedly stands to reap long term gains, as all the alternatives in one way or other urge investors to move towards better awareness and product education. It has become increasingly important for the distributor to spread financial literacy among the investor community as they depend hugely on volumes generated, and this can only happen, when investors are assured that investing in mutual funds yield realistic returns vis a vis the risk, and the ticket size of the investment is manageable.

Although investor education is being harped upon continuously, segmenting the client base, and aligning product offerings to cater to requirements of customers are also key to redefine the business and operating models to enhance key investment related value proposition.



03 Cost management, a key element of operating models

All business and operating models are central to meeting customer needs while streamlining their business processes. In order to establish a sustainable model, which will yield profits in the long run, cost management needs to be dealt with a firm hand.

The three major cost components of fund houses are as follows:

- Distribution cost - Managing the cost of distribution especially in Tier 2 and Tier 3 cities, has always posed a challenge, eroding the profit margins of AMCs. To curtail this to the maximum extent possible, technology needs to play a crucial role in enabling distributors to increase reach to the smaller towns, and help curb costs. Considering the explosion of mobile (e-commerce related) technology in India, which helps propagate this huge opportunity, the task should not prove to be as daunting.
- Hiring spend - Manpower hiring costs which has typically been a prominent contributor to the overall cost of fund houses, has had to undergo sizeable reviews to maintain its efficiency levels. More recently, it has become increasingly challenging to retain the right kind of talent in the organization.
- Spend on Marketing - Sales and Marketing expenses, which primarily comprises brokerage, claims a large proportion of total costs for AMCs, purely because the industry is still in a growth stage. Direction of profits can be identified better if these costs are managed efficiently. Further, ensuing from the restriction on entry loads, cost of sales and marketing has spiraled, as AMCs are now forced to pay out of their own pockets.

Apart from these areas, another worrisome fact is that a large portion of the assets are in debt, which actually tends to erode profits.

Industry speak:

- Escalating costs have been quite persistent, and are still on the higher side
- Distributors should be given an opportunity to earn incentives by the sale of mutual funds

Debt Expense Ratios rise, in a scenario of rising interest rates .....

It is assumed that as the size of the corpus (AUMs) increases, the cost incurred on managing the fund will come down, being shared by a number of investors and thus the expense ratios will get ironed out. However, this premise has been rendered faulty in the more recent scenario, where increase in assets under management has actually seen the rise of expense ratios. The expense ratios of income funds stood at 1.4% at the end of September 2008 with the size of income funds at Rs. 5,480 crore, which in September 2009, the size of income funds grew to Rs. 18,185 crore and the expense ratio rising to 1.58%.

04 Financial Inclusion, the new buzz word in the Financial Services sector …

Reaching out to Tier 2 & Tier 3 cities

As defined by the RBI, Tier 2 cities are those that have a population base of 50,000 and above, while Tier 3 cities have a population base upto 50,000. A survey conducted by National Council of Applied Economic Research (NCAER) in 2008 suggested that although Indians have a positive attitude towards increased savings, around 65 percent of savings are with banks or post office deposits and cash at home, while 23 percent are invested in real estate and gold and only 12 percent is channelized towards financial instruments. This manifests tremendous opportunity for growth in mutual funds, while indicating that penetration level of mutual funds in the smaller towns is lagging behind that of urban cities. As per RBI statistics, the household financial savings (net) was 10.9% of GDP in 2009, lower than 11.5% in 2008. Household investment in shares and debentures (inclusive of mutual funds), was 1.9% of GDP in 2008, which declined to 0.4% in 2009, reflecting a reduction in investor confidence in these instruments.

Steadily rising disposable income in the Tier 2 and Tier 3 cities, have showcased the latent potential for investments in mutual funds. Investors in these cities are gradually awakening to other potential investment areas like equity and mutual funds, apart from the traditional bank fixed deposits, national savings certificates from GoI, gold and real estate. It has also been observed that the HNI segment in these cities is slowly expanding, with very large amounts of investible income at their disposal.

Diversity of Indian culture implies that different models need to be explored and executed in order to make a breakthrough in these smaller towns. A few banks intend to adopt the hub-and-spoke model, gradually adding locations to each hub, where the hub could perhaps cater to 2-3 locations each.

Emergence of Stock Exchange platforms is seen as a suitable means to increase penetration levels of financial assets and thus mutual funds. Currently, it serves as an alternate mechanism for performing mutual fund transactions.

Fund Houses need to introduce lucrative products and schemes to whet the appetite of the new age investor

This method although not all pervasive, allows investors to carry out basic transactions. Cost implications point favorably towards investing directly through the investment portals (stock exchange platforms). As this mechanism gains popularity, further improvements and modifications are expected in the system, which will inevitably enhance efficiency, and provide several amenities to both investors and distributors.

CEO Comment:

- Although stock exchange platforms offer a plausible solution to increase reach, improve efficiency etc, low volumes on these exchanges, pose a concern
- Also, the number of active demat accounts for trading are quite low, making it difficult to use this as a surrogate for business planning

Targeting the HNI segment, some organizations plan to introduce “Wealth Cafes” across the nation, catering solely to the requirements of HNI’s.

To lure customers into the capital market, AMCs are pursuing investors to look upon gold Exchange Traded Funds (ETF) as an exciting option. Gold fund-of-funds are being introduced, which will invest back into their own exchange traded funds.

Industry View:

The Mutual fund industry can play a critical role in channelizing savings appropriately and participate more intensively in financial inclusion

Industry Comment:

- Conducting regular Investor awareness programs is a step in the right direction
- Fund houses are actively participating in these awareness programs; IFAs are also being trained on product knowledge to communicate the right information to investors

Investor awareness has to spread its wings to lead sustainable growth of the industry …

In today's dynamic environment, spreading financial literacy is the most critical imperative for spearheading growth in the mutual fund industry. Measures and initiatives undertaken should be structured with a long term horizon in mind, aiming to introduce innovation in products. Also, the investor education programs should be customer oriented with emphasis on the risk appetite of investors rather than simply a demonstration of the range of products.

Although, in the metros, investors are more familiar with mutual funds as a profitable investment, people in smaller towns and cities still have inhibitions about investing into mutual funds.

The rural strata of society looks for investment alternatives which primarily have a nominal initial investment, and the terms and conditions attached are simple to grasp. Most of the investors in this segment are not in a position to consider the pros and cons of the investment schemes, along with the risks attached to it, and therefore disclosures should be made very clear and apparent to the investors. In addition, products should be designed to bolster income levels of the rural segment and also increase their spending capacity. Taking a step towards inclusive growth, Fund houses have agreed to conduct investor awareness programmes from time to time.

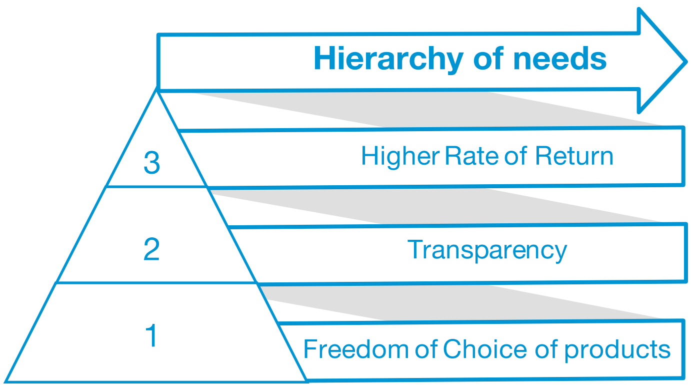
Systematic Investment Plan (SIP) has emerged as a suitable solution in this case, with a fixed amount invested at regular intervals, and most importantly being low risk.

Here again, technology needs to pave the way for bringing investors within reach of the available investment options. Various mobile applications and online services having integrated user-friendly web tools, can facilitate the spread of investor awareness in a faster and more efficient manner.

An assessment of investing drivers would give direction to the initiative of spreading awareness…

Mapping the requirements of investors today to a hierarchy of needs (akin to Maslow's model), the new age investor demands higher rate of returns, more transparency and most importantly the freedom to choose from a wide range of product alternatives. Moreover, it is essential to gauge that investor needs differ in urban cities to smaller towns, hence investor awareness programs need to be designed accordingly. Hence, while selling to "first time" customers, it is of utmost importance that all the terms and conditions attached are plainly laid out before them.

Investors need to be guided towards buying products which will fulfill their long term goals and also match their risk-taking appetite.



Having deliberated over the business aspects of the mutual fund industry, we should move to assess the regulatory environment which entwines the industry, and virtually steers the direction of the mutual fund sector.

05 The Industry adapts to Changing Regulations…

The Indian mutual fund industry is undergoing a transformation, adapting to the various regulatory changes that are coming about. We highlight some of the key ones which have undergone an amendment, impacting the industry as a whole. However, all of them primarily would seem to have the interest of the investor in mind.

Entry Load

In recent years, the industry regulator, Securities and Exchange Board of India ('SEBI') has focused more on investor protection, introducing a number of regulations to empower retail investors in Mutual Funds ('MFs'). SEBI began by prohibiting the charging of initial issue expenses, which were permitted for closed-ended schemes, and mandating that such MF schemes shall recover sales and distribution expenses through entry load only. These steps aimed at creating more transparency in fees paid by investors and helping make informed investment decisions.

Subsequently, w.e.f. August 1, 2009, SEBI banned the entry load that was deducted from the invested amount, and instead allowed customers the right to negotiate and decide commissions directly with distributors based on investor's assessment of various factors and related services to be rendered. The objective was to bring about more transparency in commissions and encourage long-term investment. Though the intent of the amendment was to benefit the investor, it has hit the margins of the Asset Management Companies ('AMCs'). Further, higher distributor commission on Unit Linked Insurance Products (issued by Insurance companies) is giving tough competition to the business of mutual funds.

No Additional Management Fees on schemes launched on "no load" basis

SEBI has scrapped the additional management fee of 1% charged by AMCs on schemes launched on a no load basis leading to a further squeeze in margins earned by the AMC.

Direct Tax Code

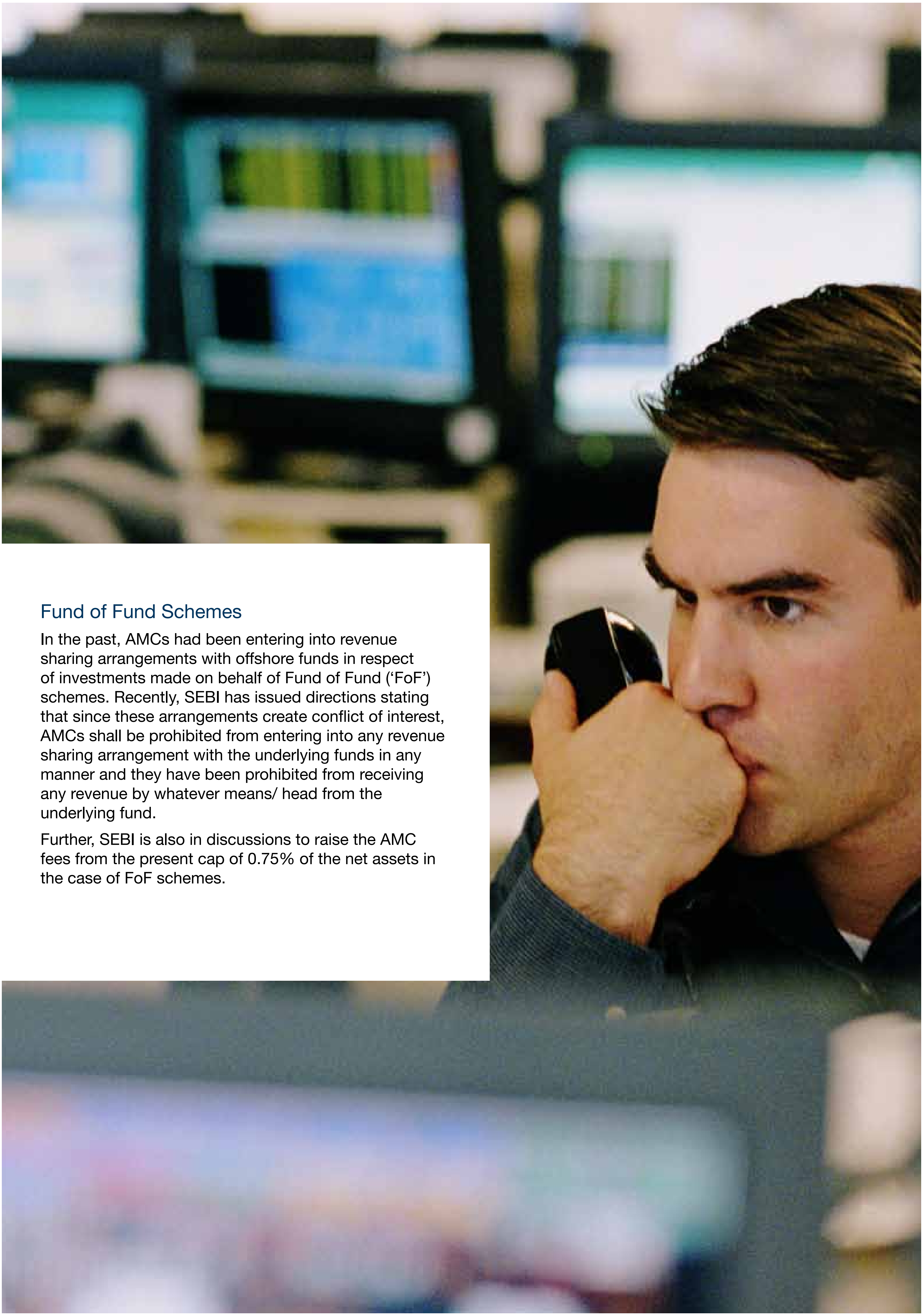
With the Direct Tax Code ('DTC') on the anvil, taxability of income from mutual funds, at the hands of investors will also have a bearing on the growth of the mutual fund industry. Unlike the extant tax provisions, DTC does not provide for any benefit for investment in equity linked savings scheme, and also proposes to increase the compliance in the hands of MFs by widening the scope of deduction of tax to include payments made to residents. The code has also created an anomaly on the taxability of the MF investors. It is unclear whether the income earned will be exempt or taxed in the hands of the investors on accrual basis, as stated in the Discussion Paper on the DTC.

Documentation

In December 2009, SEBI had made it mandatory for all AMCs to maintain a copy of full investor documentation including Know Your Customer i.e. KYC details. Such documentation was earlier maintained by the respective MF distributors who have now been asked to give a copy of the same to the fund houses.

Disclosure of Investor Complaints in the Annual Report

In order to improve the transparency in the 'grievance redressal mechanism', SEBI has recently issued a Circular that requires MFs to include details of investor complaints in their Annual Report as part of the Report of the Trustees, beginning with the annual report for the year 2009-10. MFs provide abridged booklets of the Annual Reports to all the unitholders.



Fund of Fund Schemes

In the past, AMCs had been entering into revenue sharing arrangements with offshore funds in respect of investments made on behalf of Fund of Fund ('FoF') schemes. Recently, SEBI has issued directions stating that since these arrangements create conflict of interest, AMCs shall be prohibited from entering into any revenue sharing arrangement with the underlying funds in any manner and they have been prohibited from receiving any revenue by whatever means/ head from the underlying fund.

Further, SEBI is also in discussions to raise the AMC fees from the present cap of 0.75% of the net assets in the case of FoF schemes.

06 India mapped to other global economies …

In the light of evolving regulatory frameworks, it is worthwhile to adjudge India's place with respect to other global economies. A few specific criteria have been considered as points of discussion, throwing light on the key developments which have taken place across the world.

Entry Load

India

Recently in India, the industry regulator, SEBI has instructed that no entry load be charged for all MF schemes launched on or after August 1, 2009. Distributors receive commission from the investors based on investor's assessment of various factors including service rendered. Exit loads may or may not be charged to the investors and it varies depending on the period they stay invested in the scheme.

UK

In UK, there exists a concept of front end charge of about 5% of the net assets and distributors are paid commission (typically 3%) out of this by the MFs. They are further entitled to receive trail commission of around 0.5% of the net assets annually over the period the investor stays invested in the scheme. Exit fees are also being charged by few fund houses to investors on redemption on MF units.

US

Similarly, in the case of US, both entry and exit loads are charged to investors of open-ended MF schemes. No such loads are charged in the case of close-ended schemes. For close-ended schemes, the investor pays commission directly to the distributor of the MF scheme.

China

In China, fund houses charge both entry and exit loads from MF investors. Thus, commission to distributors are ultimately borne by the investors as the MFs pay distributors from the loads charged to the investors in the scheme.

Australia

Australia does not have a concept of entry and exit load that is charged by the MF to the investors. Here, the distributors are paid commission by the MFs. Further, they may also receive fees from the investor for the advice rendered to them.

Management Fees to the Asset Management Company

India

In India, there exist statutory limits defined by SEBI for payment of management or advisory fees to the AMC. The advisory fees payable are capped at 1.25% where the net assets outstanding do not exceed Rs. 100 crores and at 1% over the net assets above the threshold of Rs. 100 crores. However, in case of index funds, the advisory fees payable to AMCs are capped 0.75% of the net assets in the scheme.

UK

In the UK, there exists no cap on the management fees to the AMC other than those stipulated in each fund's scheme prospectus. Typically fees vary on the type of fund and are usually about 1.5% of the net assets or an actively managed equity fund. Recently, new entrants in the UK market are charging lower annual management in an attempt to gain a higher market share.

US

Similar to the UK, no statutory limits are prescribed by regulatory authority in the US but it is ensured that the AMC does not earn an unfair profit from the advisory contract. AMC fees typically range between 0.50% to 1.75% of the net assets depending on the type of the fund.

China

In China, statutory caps are fixed for advisory fees payable to the AMCs depending on the type of fund. For equity-based funds, the AMC fees are capped at 1.5% of the net assets while for index funds, debt-based funds and money market funds, fees are capped at 0.5-0.7%, 0.6-1.2% and 0.33% respectively.

Australia

There are no pre-defined statutory caps on the fees payable to AMCs.The fees payable vary, inter alia, depending on the type of the fund.

Regulation of Distributors

India

In India, the distributors of the MF units are not separately regulated by SEBI or any other regulatory authority. Currently, distributors are required to take a simple test. However, there have been instances of distributors rendering professional advice to investors without the requisite qualifications and information about the MF schemes. SEBI is in discussions to introduce a more stringent certification programme for all distributors of MF schemes.

UK

Unlike in India, distributors in UK are regulated by the Financial Services Authority. In the UK there is a regulation being proposed that will require distributors of MF units to undertake certain examinations.

US

Distributors in the US are regulated by the Securities Industry and Financial Markets Association and are required to pass the securities broker-dealer exams in order to sell units of MFs.

China

MF distributors are regulated and authorized by China Security Regulatory Commission, the major regulator of the MF Industry.

Australia

The Australian Securities and Investments Commission regulates the distributors in Australia. No specified certificate is required to be obtained by distributors in Australia to entitle them to provide professional advice to investors in MF schemes.

Taxation of the Mutual Fund

India

In India, MFs are treated as a pass-through entity and hence are not liable to tax.

UK

In the hands of the MF, capital gains are tax exempt. Non-UK dividend income is taxed to the extent that it is not covered by chargeable expenses. Interest income received in case of bond funds are not liable to tax in

the hands of the MF if the income is distributed to the investors in the scheme as an interest distribution.

US

Funds are pass-through entities and only the investor pays tax upon receipt of income or capital gain distributions by the fund. MFs only pay foreign source taxes or US taxes if they fail to distribute the majority of income earned in the tax year (ie > 90%).

China

In order to promote MF industry, the tax authority in China gives nearly full tax exemptions to MF and investors. Currently, both MF and investors are not subject to any turnover or income taxes except for the institutional investors who redeem/sell the fund units. Also, dividends declared by MF are tax free.

Australia

In Australia, MFs are treated as a pass-through entity and hence are not liable to tax.

Global Front: Regulatory Changes anticipated around the corner…

Introduction of Retail Distribution Review

The key driver of change will be the retail distribution review (RDR) in the UK, which was proposed in March 2010 and will be effective in the year 2011. On account of RDR, independent financial advisers ('IFAs') i.e. distributors will move to a fee-based advice model. Post implementation of the RDR, IFAs will not be able to accept payment via commission from product providers and shall be remunerated directly by investors. Thus, investors would know up front how much the advice is going to cost and how they will pay for it.

Further, the RDR would also require IFAs to be qualified (this qualification is expected to be equivalent to the first year of a degree). It is expected that implementation of the RDR would result in a reduction of the number of distributors and only larger players would remain.

Further, the RDR, though specific to UK, is expected to spread to other European countries as well.

Alternative Investment Funds Directive

The draft legislation on Alternative Investment Funds Directive seeks to establish a harmonised framework for monitoring and supervising the risks that alternative investment funds (including venture capital funds, hedge funds, investment trusts, commodity funds, property funds and private equity funds) pose to investors, counterparties, other market participants and to financial stability, and to lay down the requirements for alternative investment fund managers ('AIFM') to provide services and market European market ('EU') funds throughout the EU.

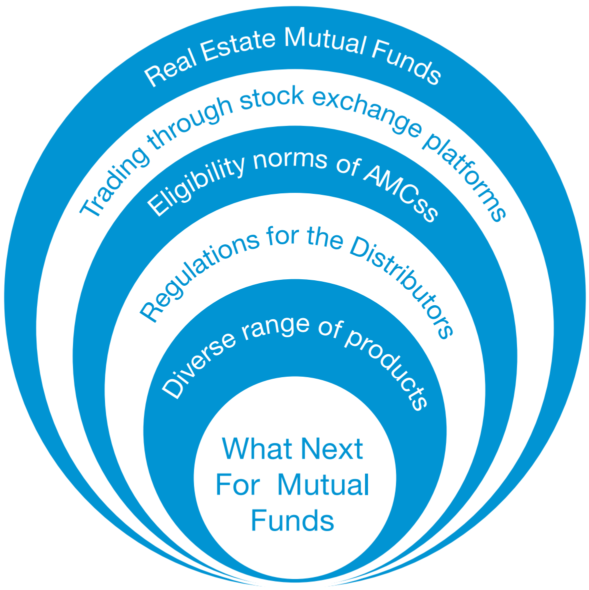
It is expected that introduction of this directive would lead to an increase in the operational cost of MF houses and also custodians of the MF's assets.

The directive also contains "third country rules," which deal with access by non-EU AIFMs to EU markets. Non-EU AIFMs who wish to sell products in the EU would now be required to be subjected to similar regulations as an EU-based AIFM. Thus, they would be subjected to appropriate cooperation arrangements between the authorities in the EU and those of the non-EU AIFM for the purpose of systemic risk oversight.

The US (where a significant proportion of EU-based funds raise capital) and the UK (where a significant proportion of EU-based funds are managed) share concerns about the likely effect of the Directive, particularly in relation to the third-country rules. In a letter to the Commission in March, US Treasury Secretary Timothy Geithner mentioned that the proposals could cause a rift between the US and the EU by discriminating against US groups in preventing them from getting a "passport" to market to EU investors.

07 What next for the Mutual Fund Industry?

Performance of the industry has been strong and it is well-placed to achieve sustainable growth levels. The way forward for the next couple of years for the mutual fund industry would be influenced hugely by the journey undertaken till this point of time and the changing demographic profile of investors.



Diverse Range of Products

There is a need for Indian MFs to come out with innovative products that cater to the ever changing customer requirements. In US, MFs provide products that cater to the entire life cycle of the investor. Diversified products will keep the present momentum going for the industry in a more competitive and efficient manner. Further, MFs have to compete with bank deposits and government securities for their share of consumer savings. Thus, in order to make MFs more acceptable to the retail investors, the MF would have to mature to offering comprehensive life cycle financial planning and not products alone.

Regulation for MF Distributors

Currently, distributors of MF schemes are not separately regulated by any authority in India. Further, many of them though certified by AMFI still leave a lot to be desired so as to render professional advice to investor and reduce mis-selling of the MF products. MFs need distributors who are able to inform the investors about the efficacy of the product for a particular risk profile and stage in their life cycle..

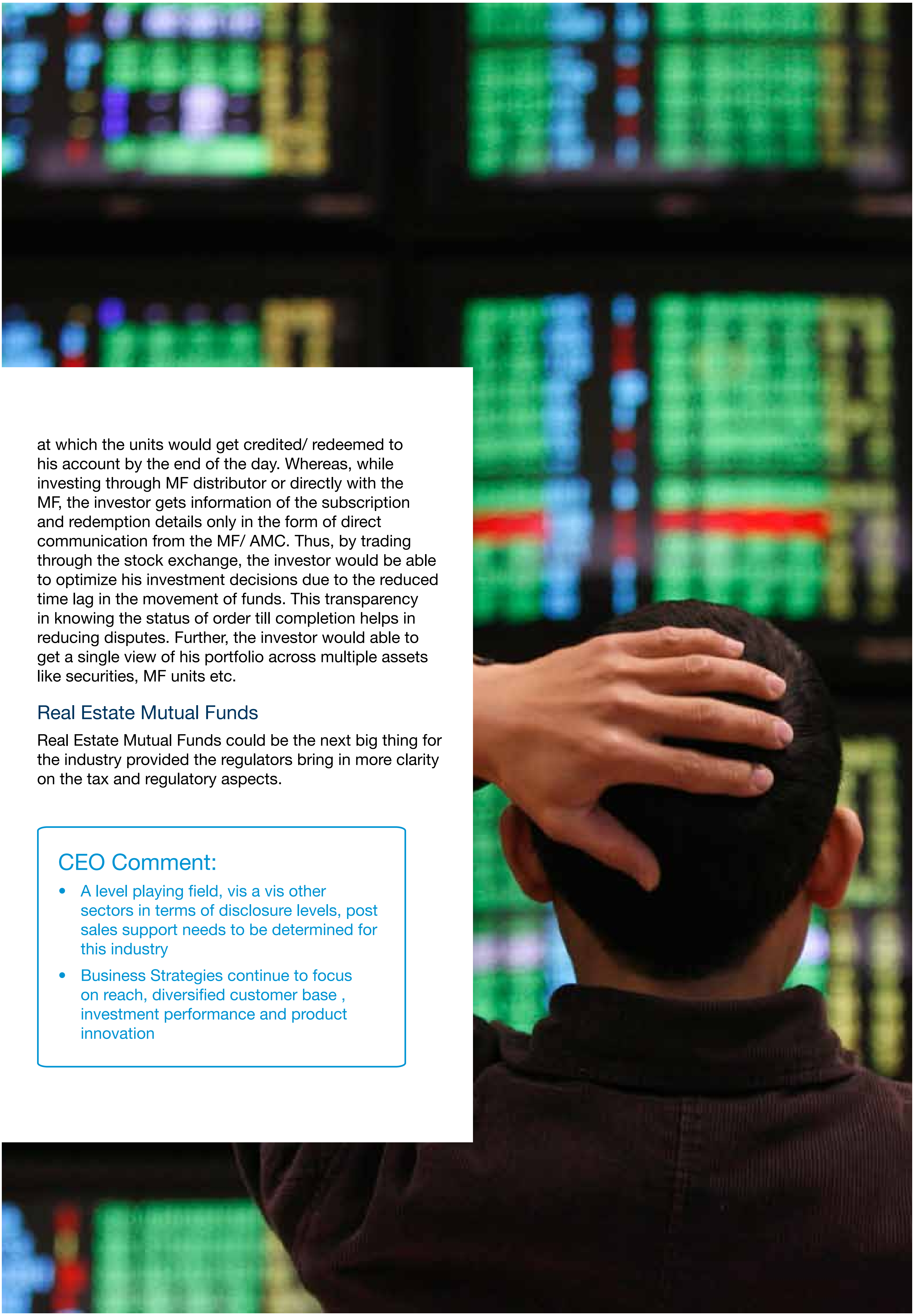
SEBI is planning to put in place a compliance certification examination (by NISM) and is expected to run it online from mid-2010. Further, SEBI is also expected to soon come out with a new set of guidelines for MF distributors. As the affluence of Indians increase, the range of financial products to meet people's need will expand and with it the need for professional financial advice from the MF distributors will increase.

Recommendations to re-visit the eligibility norms of AMCs

SEBI had constituted the "Committee on Review of Eligibility Norms" (CORE) to re-visit the eligibility norms and other functional aspects prescribed for various intermediaries. Amongst other recommendations, the key ones are relating to increase in the minimum net worth of AMCs from the existing Rs. 10 crores to Rs. 50 crores, change in the definition of net worth, sponsor to be a regulated entity and change in definition of control. The objective of the proposed recommendations is to allow only the serious players to enter/ remain in the market. The proposed changes can lead to a better governance of the MF players, thereby boosting investor confidence in the industry.

Trading through stock exchange platforms

Recently, SEBI has permitted trading of MF units on recognised stock exchanges. Subsequently, Bombay Stock Exchange and National Stock Exchange have launched trading platforms enabling investors to invest by availing services of stock brokers. While trading through the stock exchange, the investor would get to know about the validity of his order and the value



at which the units would get credited/ redeemed to his account by the end of the day. Whereas, while investing through MF distributor or directly with the MF, the investor gets information of the subscription and redemption details only in the form of direct communication from the MF/ AMC. Thus, by trading through the stock exchange, the investor would be able to optimize his investment decisions due to the reduced time lag in the movement of funds. This transparency in knowing the status of order till completion helps in reducing disputes. Further, the investor would able to get a single view of his portfolio across multiple assets like securities, MF units etc.

Real Estate Mutual Funds

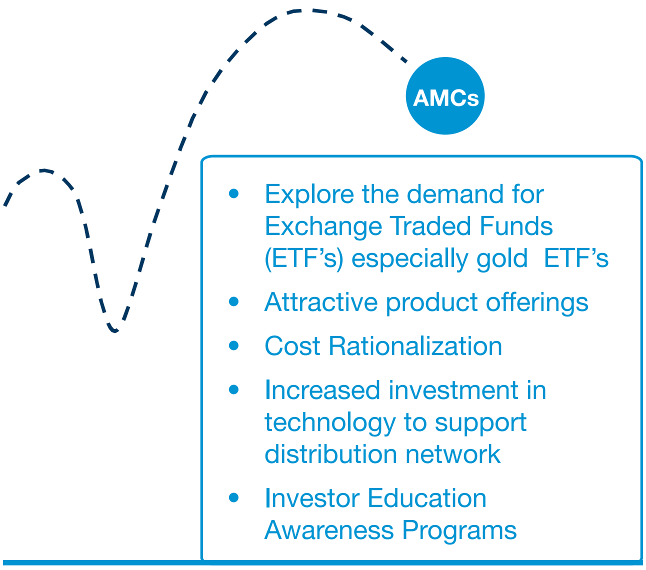
Real Estate Mutual Funds could be the next big thing for the industry provided the regulators bring in more clarity on the tax and regulatory aspects.

CEO Comment:

- A level playing field, vis a vis other sectors in terms of disclosure levels, post sales support needs to be determined for this industry
- Business Strategies continue to focus on reach, diversified customer base , investment performance and product innovation

08 In the light of the current state of the industry, and the huge latent opportunity for growth, we would like to highlight a few imperatives on this road to success…

Asset management companies today need to stay focused on a few aspects in order to ensure that the industry meets its growth objectives.



Attractive Product offerings - Asset management companies need to introduce a new range of offerings in the market in order to attract investments. The new age investor today looks for returns higher than the traditional bank deposits. Fund houses should be encouraged to design products to suit investor requirements of a higher return and with better diversification of risk.

Exchange Traded Funds - Exchange Traded Funds should be given a boost and brought into increased focus for the investor. Gold ETFs serve as a good investment option in times of market volatility. These products prove to be a viable solution for risk averse investors, without diluting the urge to have the physical asset.

Investments in technology - Fund houses need to assign an increased budget for investment in technology, which will help them streamline their distribution networks and increase efficiencies in their business. Use of technology, is a must to come up with a feasible cost-benefit business model and participate in financial inclusion, more effectively.

Investor Education - It is an unspoken responsibility of the asset management companies to spread financial literacy among investors, which will inevitably lead to increased penetration of their products. Awareness campaigns and education drives should be more regularly undertaken.

Cost Rationalization - Optimum operating efficiencies need to exist in asset management companies, and for this, cost containment measures need to be undertaken by them. Outsourcing could be looked upon as a possible measure to reduce costs, provided the risks emanating from this are better managed.

Exploring Distribution Networks from Other Sectors

It may be worthwhile to cite examples from other sectors, which have shown exemplary growth, predominantly relying on the strength of their distribution networks. A strong case here would be that of Hindustan Unilever, which has an enviable distribution network, reaching out to the rural populace. The company aims to align its offerings to the needs of this segment, after assessing their buying behavior. The company's popular initiative, "Project Shakti" has been devised to target villages with a population of less than 5000. The broad objectives of this program are –

- Reaching out to new consumers in rural areas
- Conduct consumer education programs to develop markets
- Creation of employment opportunities
- Establish a sustainable business model

This program is adequately supported by "Shakti Entrepreneurship program", which offers suitable investment opportunities and sustainable income for the people. To bring in efficiencies in their supply chain network, adequate amount of investment in technology like SAP application systems, has been made, to create better logistics.

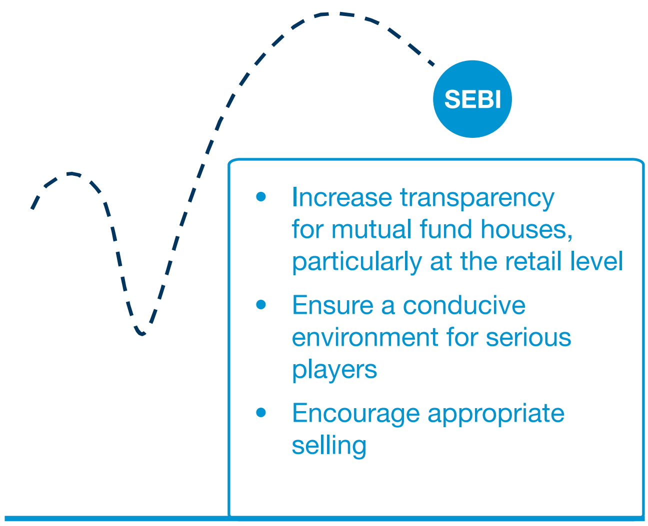
These strategies and initiatives have served their purpose, as a result of which, Hindustan Unilever showcases a customer base of over 700 million, having a reach of 6.3 million retail outlets, with over 2,000 suppliers and associates. In addition, "Project Shakti" has succeeded in equipping 45,000 Shakti entrepreneurs in rural areas, spanning 15 states, across 100,000 villages and enabled income generating opportunities.

Another example germane to the context, would be the case of demat accounts and the slow and steady journey of growth. The number of investor accounts as of April 2010 stands at 105.57 lakhs, up from 63 lakhs reported in April 2005. This increase is attributed to the growing awareness of the depository system, the tangible benefits of a "paper-less" but secure environment and the addition of an increasing number of instruments to the list of dematerialized securities, resulting in higher participation. The overall performance of the markets has also contributed to this trend. Retail participation accounts for 90 per cent of demat registrations. Even remote areas like Guwahati, Jorhat, Silchar and Tinsukia in Assam, Gangtok in Sikkim and Jammu and Srinagar, have had clients opening accounts.

Let us look at a third example of growth in a retail business. The number of Credit Cards in India has grown at a CAGR of over 18% between 2001 and 2010, from 4.87 million to 22.6 million, while Debit Cards in India has witnessed a compounded growth of over 37% between 2005 and 2010, from 35.5 million in 2005 to 173.2 million in 2010. Complementing this, the number of ATM outlets, have grown at a CAGR of 34% between 2002 and 2010. The reach of such cards is gradually expanding, with coverage extending beyond Tier 1 and Tier 2 cities. Interestingly, among prime concerns faced by the "card industry" in penetrating the smaller towns and cities are lack of awareness of secure online transactions, logistics of card distribution and high cost of acquiring a merchant establishment.

It is time perhaps for the asset management industry to look to these sectors, and pick up a few pointers on strengthening distribution, with a focus on inclusive growth, considering that the challenges faced to capture the market beyond Tier 1 & Tier 2 cities, would be somewhat similar.

While fund houses concentrate on the above mentioned areas, it would also be important for the market regulator to continuously help create a favorable environment for growth of the industry. The nature and the cost of disclosures to retail clients need to be looked at simultaneously, to help determine a more effective model and enhance levels of financial literacy.



Appropriate Selling - The selling of mutual funds does not have a specific set of regulations outlined to follow. Measures should be initiated to avoid mis-selling of products, with guidelines communicated to all distributors, whether they are banks, distribution houses or IFAs.

Increased Transparency - Disclosure requirements should hold consistently across all asset management companies in order to institutionalize greater transparency in the system. Information should be readily available and communicated effectively to investors, for them to take informed decisions.

Conducive environment for serious players - Regulations should be formulated to encourage and support more serious players in the market, who help bring in more investor awareness.

Inclusive growth to define the pace and pattern of growth in the Industry

We can in effect conclude by saying that all efforts at the moment are being synchronized towards attaining the objective of financial inclusion. The drive to expand reach beyond Tier 1 cities and make mutual fund offerings available to people in smaller towns and cities has indeed taken up the attention of the industry. However, several components of such an initiative, like investor awareness, broadening investor participation and product innovation, need to be aligned in order to fully establish inclusive growth. The industry needs to give due emphasis on the above factors, drawing out an efficient business and operating model to ensure that the inherent challenges that the industry is facing is efficiently dealt with. Designing a competent and all pervasive business model has all the more become important in the current scenario of changing business and regulatory legislations. At a time when amendments to key regulations are being analyzed in terms of impact on the business of the industry, it remains to be seen, how the pace and pattern of growth of the industry takes shape.

Acknowledgements

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Anish Patel

Harshal Kamdar

Malvika Singh

Mousumi Ghosh

Muskkan Kukreja

Nandini Chatterjee

Nehal D Sampat

Trisha Chatterji

About
Confederation of Indian Industry

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 115 years ago, it is India's premier business association, with a direct membership of over 8100 organisations from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 90,000 companies from around 400 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 environment, to name a few.

CII has taken up the agenda of "Business for Livelihood" for the year 2010-11. Businesses are part of civil society and creating livelihoods is the best act of corporate social responsibility. Looking ahead, the focus for 2010-11 would be on the four key Enablers for Sustainable Enterprises: Education, Employability, Innovation and Entrepreneurship. While Education and Employability help create a qualified and skilled workforce, Innovation and Entrepreneurship would drive growth and employment generation.

With 64 offices in India, 9 overseas in Australia, Austria, China, France, Germany, Japan, Singapore, UK, and USA, and institutional partnerships with 223 counterpart organisations in 90 countries, CII serves as a reference point for Indian industry and the international business community.

Contact

Dev Ranjan Mukherjee
Head - CII Gujarat State &
Head - Conference
Confederation of Indian Industry
Western Region - Gujarat State Office
CII House
Gulbai Tekra Road
Near Panchwati
Ahmedabad - 380 006
Phone: 079 40279900 - 10
Fax. 079 40279999
Email. dev.mukherjee@cii.in

Rima Kothari
Executive Officer
Confederation of Indian Industry
105, Kakad Chambers
132, Dr Annie Besant Road,
Worli, Mumbai - 400018
Phone: 022 24931790
Fax: 022 24945831/ 24939463
Email: rima.kothari@cii.in

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Contacts

Jairaj Purandare
Executive Director
Phone: +91 22 6669 1400
Email: jairaj.purandare@in.pwc.com

Harsh Bisht
Executive Director
Phone: +91 22 6669 1282
Email: harsh.bisht@in.pwc.com

Gautam Mehra
Executive Director
Phone: +91 22 6689 1155
Email: gautam.mehra@in.pwc.com

Robin Roy
Associate Director
Phone: +91 22 6669 1360
Email: robin.roy@in.pwc.com

pwc.com/india

PricewaterhouseCoopers Contacts

Ahmedabad
President Plaza, 1st Floor, Plot no. 36
Opposite Muktidham Derasar
Thaltej Cross Road, S.G. Highway
Ahmedabad - 380054, Gujarat
Phone: +91 79 3091 7000

Bangalore
5th Floor, Tower "D", The Millenia
1 & 2 Murphy Road, Ulsoor
Bangalore 560 008
Phone:+91 80 40794000

Bhubaneshwar
IDCOL House,Sardar Patel Bhawan
Block III, Ground Floor, Unit 2
Bhubaneswar 751009
Phone: +91 674 2532 459, 2530 370
Fax: +91 674 2531 674

Chennai
PwC Centre
32, Khader Nawaz Khan Road
Nungambakkam
Chennai- 600 006
Phone: +91 44 5228 5000
Fax: +91 44 5228 5100

Hyderabad
#8-2-293/82/A/1131A
Road No 36, Jubilee Hills
Hyderabad 500 034
Phone: +91 40 6624 6600

Kolkata
5th Floor, Sukh Sagar
2/5 Sarat Bose Road
Kolkata , West Bengal 700 020
Phone: +91 33 24575 2910
Fax: +91 33 2485 8897

Plot No Y 14, Block EP Sec V
Salt Lake Electronic Complex
Kolkata , West Bengal 700 091
Phone: +91 33 2357 7200/9100
Fax: +91 33 2357 3394/95

PwC Center
56 & 57, Block DN
Sector V, Salt Lake
Kolkata 700 091
Tel: +91 33 2341 4234
Fax: +91 33 2357 2754/3395

Mumbai
252 Veer Savarkar Marg
Shivaji Park, Dadar
Mumbai 400 028
Phone: +91 022 66691500
Fax +91 022 5654 7804/ 05

PwC House
Plot 18/A Guru Nanak Road
(Station Road)
Bandra West
Mumbai 400 050
Tel: +91 22 6689 1000
Fax: +91 22 6689 1888

New Delhi
Sucheta Bhawan
11 A Vishnu Dighambar Marg
New Delhi 110 002
Telephone +91 11 2323-2916/2321
Fax: +91 11 2321-0594/96

PricewaterhouseCoopers Pvt. Ltd.
Building 8, 7th & 8th floor,
Tower B, DLF Cyber City,
Gurgaon 122002,
Haryana, India
Telephone: +91 124 4620000
Fax: +91 124 4620620

Pune
Muttha Towers
5th Floor, Suit No. 8
Airport Road, Yerwada
Pune 411 006
Tel: +91 20 4100 4444
Fax:+91 20 4100 6161

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