Confederation of Indian Industry

Mutual Fund Summit 2014
CII's 10th International Conference
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Indian mutual fund industry at a glance

Indian mutual fund industry
Challenging the status quo, setting the growth path

pwc

Chairman's message

The mutual fund industry spanning almost two decades now has seen its share of success and failure. It is quite commendable that we have reached a mark of almost 10 trillion INR of assets under management as of May 2014. This has been a result of collaboration of all industry stakeholders like the distributor, the asset management company and the regulator who has shaped the way forward for the industry.

Having said that, participation from metros too remains low if we go by the number of investors and increase in wallet share. There is also a concern of having investors stay invested in mutual funds and perceive the long-term benefits of the product. Investors need to realise that mutual funds is a way to meet their financial goals and not just a means of short-term financial gain. Given the current scenario of market volatility and uncertainty, the investor perceives investments in the capital market to be risky and unsafe, and hesitates to channelise his savings into mutual fund products. Fund managers need to instil that confidence in the minds of investors and encourage them to stay invested in funds to derive the desired benefits.

The decade edition of the Mutual Fund Summit looks to assess how the mutual fund industry has evolved and transformed over the years, maturing with every development that is taking place. It also places focusses on the gaps and issues that remained to be addressed in terms of the product, the distribution and the investor.

This report by CII - PwC titled 'Indian mutual fund industry: Challenging the status quo, setting the growth path' discusses how the industry can challenge itself and draw perspectives from other markets and industries to reach the next level of growth.

We hope you find this report insightful and useful. We welcome your comments or suggestions.

A Balasubramanian
Chairman, CII Mutual Fund Summit 2014
Chief Executive Officer, Birla Sun Life Asset Management Co Ltd

Foreword

As we celebrate the completion of a decade of the CII Mutual Fund Summit, it gives us immense pleasure to be a part of this journey with CII and share our thoughts and perspectives by way of this background paper, and especially at a time when India is poised at an interesting and exciting juncture, with hopes of seeing a sustained good run.

This year, the paper titled "Challenging the status quo, setting the growth path", on the one hand, takes a look out globally and into the future, and on the other, takes a look inside and into the past. The report showcases a global perspective elaborating on some of the global trends, strategic drivers and cross-border distribution, while highlighting the game changers in the industry, and does some crystal ball gazing into future projections. It also traces the growth of the Indian mutual fund industry in the last two decades, and assesses how the industry has evolved in terms of schemes, products and companies. Compared to the global landscape where the AuM to GDP ratio averages 37%, the ratio in India stands at 7 to 8%.

The report tries to capture the various areas where status quo exists in terms of investor mix, alternative products and the advisory model and distribution of products. The report also explores some of the solutions on how this status quo can be addressed with examples of pricing, product positioning and product relevance.

The report goes on to encapsulate a few regulatory updates not only from India, but across global markets including some of the directives like FATCA and fund passport, which are giving a new shape to the mutual fund industry.

We hope you find this report a considerable value add and welcome any thoughts on improving this report in the following year.

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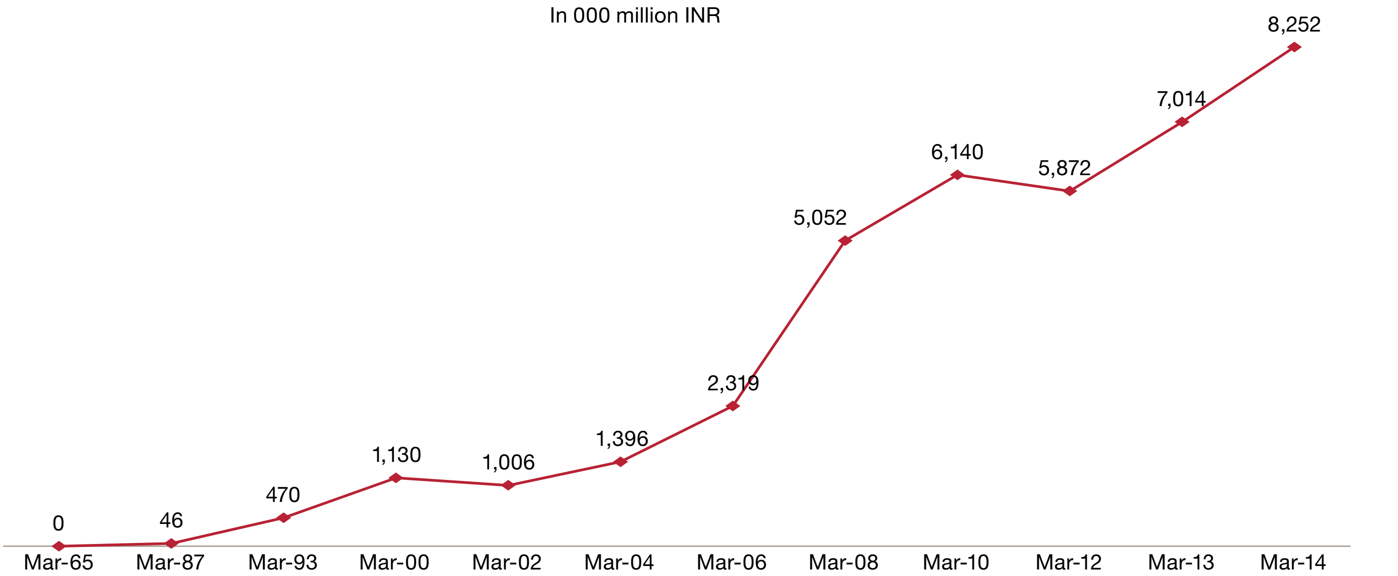
It has been a little over 20 years since the asset management industry was opened up to the entry of new players. The objective was to expand the business by widening and deepening the market for asset management products. The inclusion of asset management products in the basket of traditional investment avenues such as cash-in-hand, corporate and fixed deposits (FDs), savings accounts, stocks and gold was expected to occur over time.

The mid-90s saw the emergence of stock investment trends with large-scale retail investments in the primary and secondary stock markets. The IPO boom of the early 90s saw retail investors opting to invest a significant portion of their investible surpluses in the stock markets. The enhanced liquidity chasing stocks correspondingly saw a surge in the BSE Sensex from under 2000 in 1992 to around 5000 as on 31 March 2000.

The same period also saw the asset management industry expand rapidly in terms of number of schemes, products and companies. Considering the industry is still relatively young, its evolution and growth over the two decades is impressive. This is true in all aspects and not just about the scale of growth of assets under management (AuM). It applies to the creation of evolved products as well as the human capital and skill development. The ecosystem including support and outsourced functions has been created and knit together almost from scratch.

The regulatory regime kept pace with the changing environment and the AuM of the asset management industry grew from 470 billion INR in 1993 to 1396 billion INR in 2004 and to 8252 billion INR in 2014.

AuM growth



It has been two decades since the regulators set the industry on the path to growth and expansion. Therefore this is perhaps a good time to step back, take a look and assess in order to help chart the course for the next decade.

The global perspective

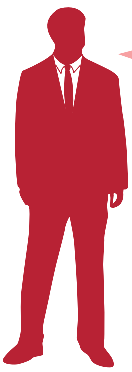
Industry ecosystem

The global asset management industry footprint by product and investor

There is rich diversity in the sector as the asset management industry offers a mix of traditional mutual fund products and alternatives (real estate and hedge funds). The investor universe that the industry taps covers insurance funds, pension funds, sovereign wealth funds (SWFs) and high net worth individuals (HNWIs) /mass affluent/retail investors.

In 2012, the global asset management industry managed 36.5% of the assets held by pension funds, SWFs, insurance companies and HNWIs/ mass affluent. This represents a huge pool of investible resources that global industry players are able to tap into.

It is evident that Indian asset management addresses only a subset of the investors that its global counterparts do. The regulatory mandates in place in evolved economies allow access to the insurance and pension sectors. The industry structure possibly looks to create and harness core competencies in asset management. Industries such as insurance and pensions are allowed to invest in markets via asset managers with regulated and calibrated exposure levels.



The ability to tap into fund pools with the insurance and pension segments will be key to growth.

Global trends

We believe the trends of products, customers and distribution and operations, to different degrees, will be relevant to most major markets and geographies.

Product	• Alternatives to go mainstream with retailisation • ETFs here to stay • Retirement products
Customer / distribution	• Fund houses seeking global growth opportunities • Big data analytics becoming important to identify opportunities and customer needs • Continuing transparency and information requirements
Operations	• Multiple drivers for investing in technology • Outsourcing being re-examined over concerns about loss of data/control and fiduciary requirements • Recordkeeping complexities

Global strategic drivers

Strategic drivers are shaping the business as we speak and will continue to be relevant in the near future. The relative importance of one or the other of these will differ from market to market.

Customers

- Life insurance cos experiencing severe challenges to their business models
- An increasingly sophisticated and aware customer base seeking value in their investment providers
- The changing and lengthening retirement journey
- Growing propensity around DIY behaviour online

Investors

- High demand for income, in the form of dividends
- Higher returns on offer in other/overseas markets – shareholders seeking to extract cash / capital to redeploy

Key challenges for asset managers

- Maintaining / growing volumes and revenues
- Re-positioning cost bases for value growth
- Balancing sustainable profit and customer outcomes
- Generating cash and attractive shareholder returns
- Avoiding regulatory intervention (S166 in the UK)

Regulators

- Regulatory scrutiny continues around three themes:
  - Customer protection (MiFID II, RDR in the UK, FCA, AIFMD)
  - Fairness for customers
  - Tax (FATCA)
- Higher cost and focus on evidencing compliance with pressure on excessive returns

Distributors

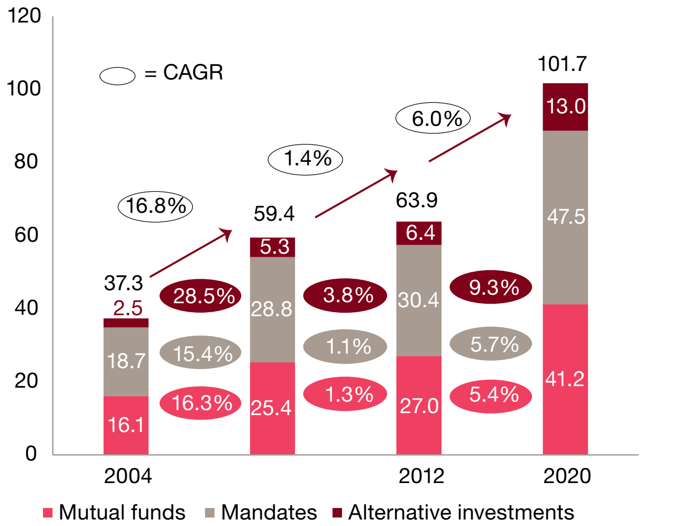
- Distributors moving towards ownership of the customer
- Seeking providers who can help them reduce costs in other ways
- Rebuilding a new ‘value chain’

Growth trends and expectations

In 2012, the global aggregate AuM with asset managers stood at 64 trillion USD. This broadly comprised mutual fund assets (27 trillion USD), mandated AuM (i.e. asset allocations from global pension funds, insurance industry, SWFs, etc for the management/advisory services of asset managers; 30.4 trillion USD) and alternative investments (6.4 trillion USD).

The global aggregate AuM is expected to exceed 100 trillion USD by 2020! The components of that figure are expected to grow. Significant growth is expected in mandated AuM as well as alternative investments.

AuM in trillion USD

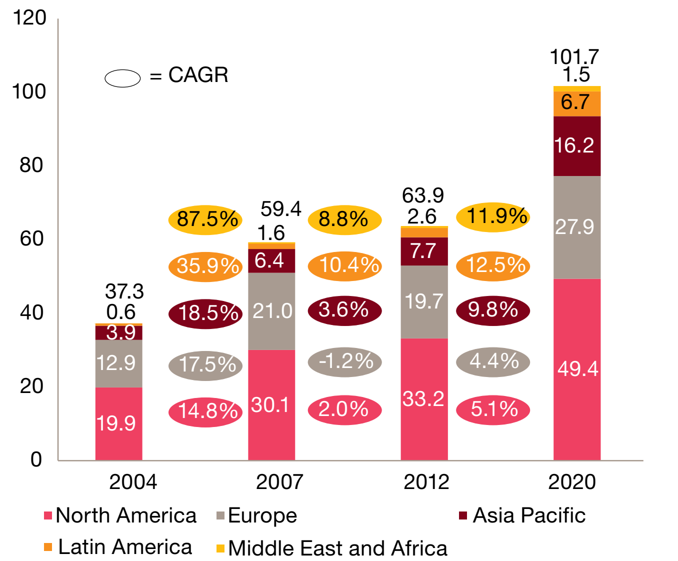


The growth of global investable assets will be driven by five main trends:

- The rise in retirement savings as the aging of the world's population continues.
- The increased weight of the SWF market as new SWFs are formed and assets double.
- The shift in emerging markets from savings to investing cultures.
- The rise in wealth accumulated by HNWIs and mass affluents.
- The move by traditional defined benefits in developed markets into alternative investments.

The South America, Africa, Asia and the Middle East (SAAME) region is expected to see the highest growth rates over the period to 2020.

AuM in trillion USD



- From 2012 to 2020, the growth rate of global AuM will be lower in non-SAAAME regions than in SAAAME regions.
- This is because the rise in wealth is greater in SAAAME than in non-SAAAME regions.
- In addition, the market is more mature in non-SAAME than in SAAAME regions.

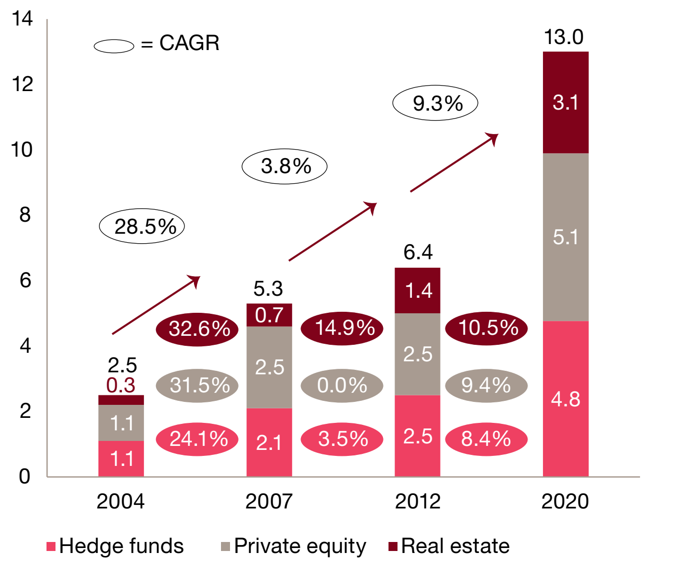
Alternative and exchange-traded products (ETP)

Globally, the alternative assets segment has grown and evolved at a rapid pace and the considered global view is that alternatives and ETPs will grow at a faster pace in the future.

The Indian asset management industry is virtually synonymous with mutual funds and exchange traded funds (ETFs) and alternatives are yet to find significant traction in our environment.

While it is a given that not every asset manager should or will occupy all segments of the industry, there is an opportunity to widen the offering and to bring on board alternative products relevant to and that leverage the existing skill sets and capabilities of the Indian market.

Global alternative assets in trillion USD

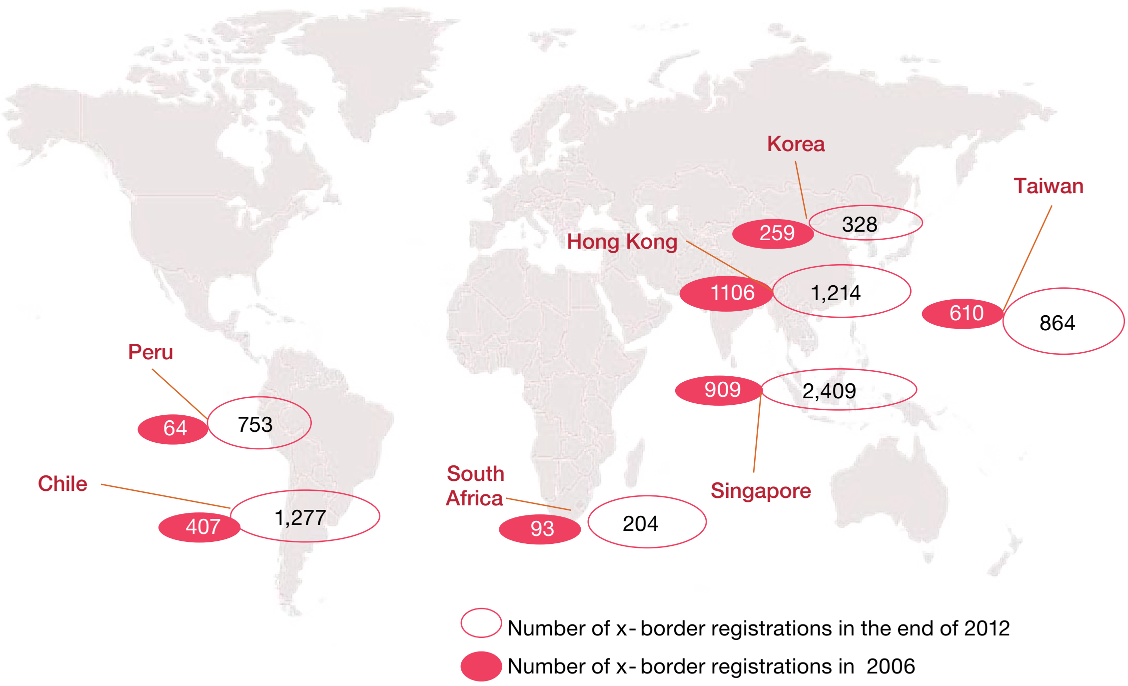


- Alternative assets are expected to grow by 9.3% until 2020.
- The growth of alternatives will be driven by existing and emerging HNWIs and SWFs.
- Despite significant regulation of the sector, the demand for alternatives will continue to grow. Investors in search of greater alpha will broaden their exposure to include alternatives, especially in the current low yield environment.

Cross-border distribution

There have been significant moves by Asian and Latin American (LATAM) peers in the area of global fund distribution, with a significant number of cross-border registrations. PwC believes that regional blocks will emerge–North Asia, South Asia, LATAM and Europe–across which products will be sold pan-regionally. As these frameworks develop, asset managers will need to look again at their distribution challenges and strategies as access to and for new investors becomes a reality.

UCITS registration growth in Asia and LATAM (2006 to 2012)



Retail distribution

The distribution models continue to evolve and so do the associated cost/fee structures. This is taking place on account of not just downward pressure on costs but also to better align distributors and investors.

Recently the Financial Services Authority in the UK undertook an exercise to study and recommend changes to retail distribution models and practices. This exercise was commonly referred to as the Retail Distribution Review.

The global perspective: Conclusion

- Over half of the AuM of the global asset management industry is in areas other than traditional mutual funds. Mandated and alternative assets comprise almost 60% of the total industry AuM and the latter segment is growing rapidly. The asset management industry is growing to a stature comparable to banking and insurance.
- While the debate about Indian AMCs accessing the domestic pension corpus will continue, a significant portion of global pension and insurance funds is allocated for investment in Asian capital markets including India. The opportunity to render investment advice to such fund managers is immense. We understand that it will not be easy to win such mandates but the effort would be worth it. It is estimated that 17 to 20% of Indian market capitalisation is held by foreign funds. However, a remarkably small fraction of these funds are advised and managed by Indian asset managers.
- Investors are showing increasing interest in and demand for alternative investment assets.
- Distribution models and the costs involved are constantly being re-examined. Distribution is expected to go 'glocal'.
- Technology continues to remain critical.

We believe the six gamechangers in the asset management space to be as follows:

- Asset management will move centrestage.
- Distribution will be redrawn such that regional and global platforms will be redrawn.
- Fee models will be transformed.
- Alternatives will become more mainstream, passives will become core and ETFs will proliferate.
- There will be a new breed of managers.
- Asset management will enter the 21st century.

Taking stock: A view from the outside

Share of the investment pool

While the industry has grown significantly and there is much to be satisfied about, there are opportunities for improvement too.

While the AuM has grown from approximately 470 billion INR as on 31 March 1993 to approximately 8,250 billion INR as on 31 March 2014 (reflecting a CAGR of 14.6% over the last 21 years), the Sensex has grown from approximately 2280.52 as on 31 March 1993 to 22,386.27 as on 31 March 2014 (reflecting a CAGR of approximately 11.5%). Quite naturally, the growth of the Sensex and the AuM feed off one another and thus a portion of the AuM growth can be attributed to the growth of underlying stocks and indices.

Perhaps it might be useful to revisit the broad savings and investment basket to help us review industry progress and growth.

The industry has seen net flows of approximately 4900 billion INR from 2001 to 2014 (an average of 352 billion INR per annum). The change in the financial assets (gross financial savings) of the household sector in FY2012-13 was approximately 109,69 billion INR, of which mutual funds attracted 274 billion INR (approximately 2.5%). Compared to this, the amount held in currencies was approximately 10%, the amount invested in deposits approximately 56%, life insurance gathered approximately 16% and pensions and provident funds gathered approximately 14.5%. Moreover, change in financial assets accounted for only a third of total household savings, the remaining two-thirds held in physical assets such as gold and real estate. Would it therefore be fair to say that mutual fund products do not enjoy what might be called a 'fair' share of the wallet? Are the mutual fund products competing successfully against alternatives such as FDs, gold and lately real estate?

Mutual fund penetration in India is low as compared to global and peer benchmarks. The AuM to GDP ratio stands at 7 to 8% as compared to a global average of 37%. Even the SAAAME economy of Brazil, considered a peer emerging economy, is significantly ahead, with an AuM to GDP ratio of 45% (Source – AMFI, ICI FactBook 2013).

Increasing mutual fund penetration will largely depend on increasing investor awareness at grass-roots level and providing access to financial services to the still largely unbanked population.

In its effort to increase investor awareness, the industry and the Securities and Exchange Board of India (SEBI) have launched several initiatives. These include literature and campaigns to propagate financial education to various investor segments (including potential investors), such as school and college students, homemakers, executives, etc.

The two-pronged approach of increasing awareness of and access to financial products and services has and will go a long way in increasing the penetration of mutual funds in the country.

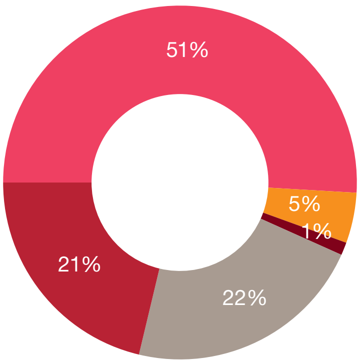
While it might be uncharitable to compare this with similar data from western economies, important lessons can be learnt from them as well, when looking forward.

Investor mix

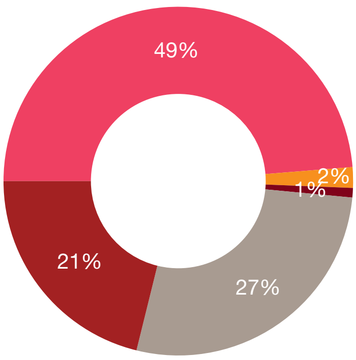
The asset management industry held 39.5 million folios as on 31 March 2014, which has declined from around 47.6 million as on 31 March 2009. The composition of the sources of investment for the industry as a whole in 2009 and in 2014 is given here. This shows that the industry has not managed to improve the share of retail and individual investors in the AuM of the industry over the last decade.

The charts below depict AuM from three perspectives – by investor type, by geography and by investment type. Typically, corporates have the lion's share of the total AuM, which is concentrated in the top five cities. Most of the investments have been found to be in income funds followed by equity.

Break up of AuM by investor type (2009)

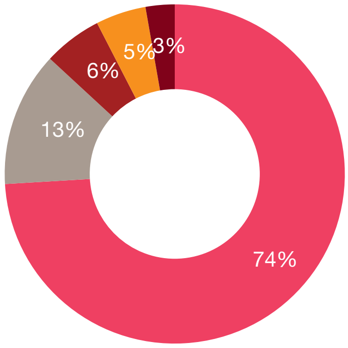


Break up of AuM by investor type (2014)

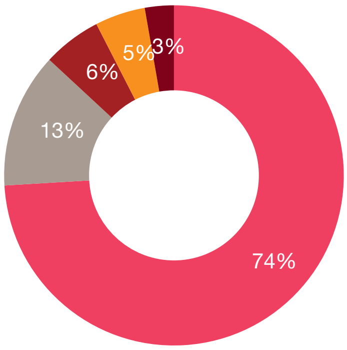


The share of AuM from the top metros has remained relatively high and recently SEBI has amended relevant guidelines to improve the economics of selling to investors in cities other than the top 15. This was done to revitalise mechanisms for reaching the larger mass investor in Tier 2 and 3 towns, not only through distribution economics but by enabling distribution through multiple channels such as retired government employees, etc.

AuM by geography (2013)

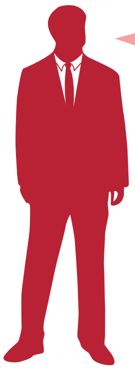


AuM by geography (2014)



In the immediate period since the above, there has not been a discernible change in statistical trends as yet. The industry AuM from towns other than in the top 15 was approximately 871.4 billion INR as on 31 March 2012 and was approximately 1126.5 billion INR as on 31 March 2014 (reflecting a CAGR of approximately 13.7%). This translates into 14.84% and 13.65% of industry AuM in the respective years.

Yet, it is true that there are investible surpluses available in cities beyond the top 15, at least more than what has been tapped by the asset management industry so far.

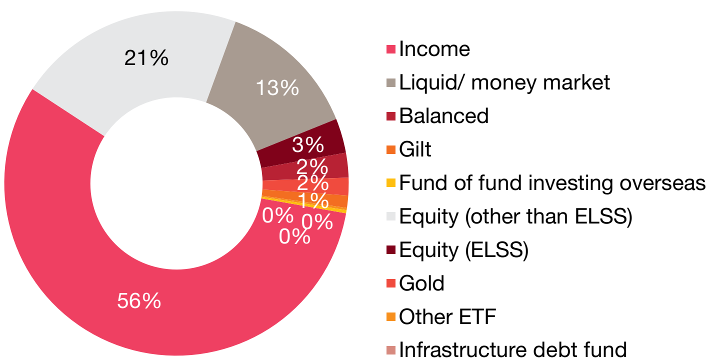


The amount of data and information needed to be published by the mutual fund industry is significantly more than for any other financial product. The utility value of it as perceived by an investor needs to be ascertained.

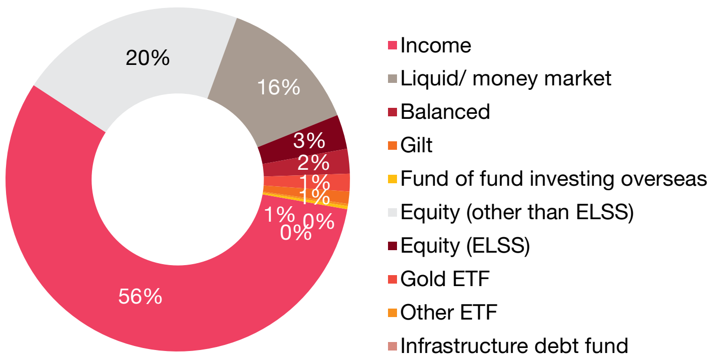
Product basket

Over the years the industry has developed an extensive product basket covering various investment opportunities. However, the 80-20 rule applies. Over 80% of the AuM is in less than 20% of the product categories. Is there room for simplification of the product basket?

AuM by Investment Type (2013)



AuM by Investment Type (2014)



Sales and marketing

The industry has been operating on what we know as the 'open architecture' distribution model, with no tied agents. Although the ability to invest directly now exists, the industry is largely reliant on the distributor fraternity at the front end.

Over the years, the distribution economics have been changed to correct a few anomalies such as churn, etc. However, as things stand, the number of AMFI registration numbers (ARNs) has declined from around 82,015 as on 31 March 2011 to 58,167 as on 31 December 2013.

The industry needs to analyse this trend in all its aspects. Unfortunately, there may not be a 'one-size-fits-all' solution that will work.

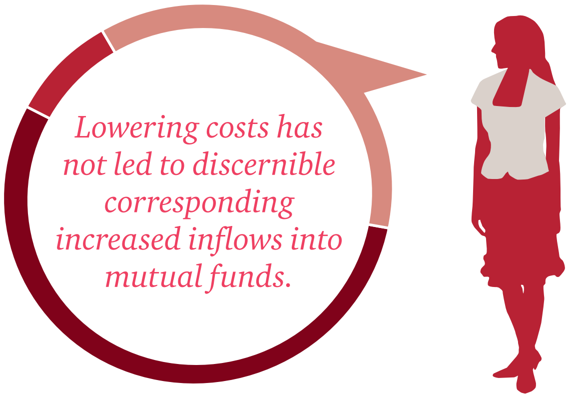
The Status Quo

When we take stock along the above lines, several aspects seem to surface.

- **Share of the investment pool:** The industry has no doubt grown but it is yet to take away significant market share from other traditional investment products. While all fund houses make concerted efforts at investor education with camps and campaigns, the products of the industry are reaching nowhere near the kind of primacy in the investor's mind.

- **Investor mix:** The investor mix has remained almost static with non-retail participation remaining high and the bulk of investors coming from the top 15 cities.

- **Alternative products and advisory model:** While the industry offers a wide variety of mutual fund products, only a few garner the lion's share of the AuM. Non-mutual fund products and services (alternatives and advisory) are yet to take off significantly.
- **Distribution:** The industry has always worked within the 'given' of an open architecture distribution model and while a few efforts have been made at exploring additional and different channels of distribution, they have not significantly augmented the existing distribution structure.



As the industry embarks on its third decade, this presents an opportunity to assess and chart new exciting courses by challenging the status quo with the objective of catapulting the industry into the next level of growth and taking it to the position that it enjoys in other developed economies.

Challenging the Status Quo

Status Quo one: Share of the investment pool

This remains a stark issue for the industry despite tireless efforts by all constituents. The industry still garners less than 3% of the incremental investible surplus from the household financial savings pie.

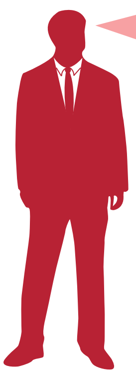
As the culture shifts from savings to investments, there is an opportunity to gain additional market share. However, this will require appropriate and relevant products, pricing, positioning and sales.

- **Product relevance:** The industry offers a basket of products which at times seem over-crowded and complicated, yet the front-line sales function remains unclear about the right product for each type of investor.

A mis-sold product is unlikely to deliver the benefits needed, desired or expected and will probably lead the investor not to return.

- **Pricing:** With respect to the asset management industry this refers to the charges and costs associated with the investment. In this respect, while there is a tremendous amount of information available from the asset managers, most investors are likely to be unaware of brokerages incentives, etc.
- **Positioning:** In any market product-positioning is a critical aspect; how to position the product in an overcrowded space; in a way that attracts greater attention as compared to competitors.

Traditional alternatives such as FDs and gold have continued to dominate and recently, real estate investments have attracted a large portion of the investible surplus. The challenge for the asset management industry is to enhance the visibility and profile of its products in the mind of the investor. This means communicating the relevance of the products and their benefits.



Additional tax exemptions over and above current tax exemptions for investment in mutual funds will create an immediate 'pull' demand for products and all taxpayers will become mutual fund clients with almost nil acquisition cost.

The development of mobile technology and the emergence of social media offer individual investors innovative ways to access and scrutinise the investment fund industry. It also presents a new challenge for the fund promoters who are required to evolve their marketing strategy and accommodate, leverage these new communication channels.

For instance, in the UK, one of the biggest fund distributors is already proposing an application on iPhone allowing clients to acquire information regarding fund price, performance and management fees on a range of more than 1000 funds. Clients will also have the opportunity to invest through the fund platform.

It is already possible to very specifically target a desired audience set through social media analytics. This enables marketing teams to focus their messages toward the desired target audience more specifically and tailor the messages appropriately.

Status Quo two: Investor mix

In many ways investor mix is related to market share. Any correction will involve accessing new investors, which will go some distance towards tackling the investor mix issue as well. The regulator has actively been encouraging the industry to go to the investors beyond those in the top-15 cities. Incentive structures are in place and regular monitoring of outcomes is required; the impact of the thrust is yet to be seen in a significant manner.

Perhaps simple low-cost products (debt funds, for example) will be good starting points for first-time investors. A significant number of retail or prospective investors perceive mutual fund investments as surrogates or equivalents to stock ownership. First-time investors can be encouraged to start with simpler, relatively low-risk products, which are more yielding than alternatives such as FDs. An investor needs to evolve towards investing in higher-risk products and to construct his or her portfolio appropriately. Such an evolution can be mutually rewarding for investors and for asset managers.

Status Quo three: Alternatives and advisory

The vast majority of funds under management with the Indian asset management industry are invested in traditional mutual fund products. While some fund houses have additional activities such as advisory services for foreign funds, PMS, this still is a small beginning.

Even within this, the number of schemes that spawned over the last decade is large leading to operational costs and inefficiencies. Statistically, a handful of scheme types have consistently garnered the largest share of the AuM; the industry needs to better leverage costs and skills by broad-basing its product and service offerings.

It also needs to better leverage the costs and skills by broad-basing the product and service offerings.

As noted earlier, from a global perspective, industry peers across the globe employ a far wider solution-offering and thus are able to tap a wider basket of investors.

A recent trend saw the real estate sector draw a lot of the investible surplus from the HNWI segment. The potential introduction of the REITS infrastructure investment trusts is likely to permit investors to participate in the yield products of the sector.

Status Quo four: Distribution

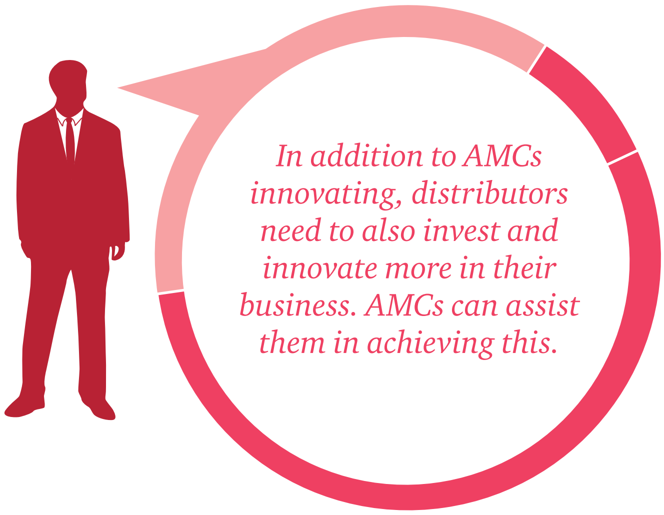
The distribution challenge has remained a point of discussion over the years. While the rules of the game have now changed to eliminate aberrations and anomalies, some issues remain. Fund houses have enabled the direct investment route but only a small percentage of fresh subscriptions are generated through this window.

Often, a comparison is drawn between the compensation structures for distributing competing products vis-a-vis those offered by the asset management industry. However, once the blend of up-front and trail compensation is considered and keeping in mind that the AuM for trail computation can naturally grow in the long-term, the difference over a period of time is not as wide as it might appear at first glance.

The challenge really lies in aligning interests between the three stakeholders; investors, fund houses and distributors. As long as the fund is paying commission to procure AuM there may be issues of interest alignment and the revised compensation structures; a blend of up-front and trail compensation which partially addresses the issue.

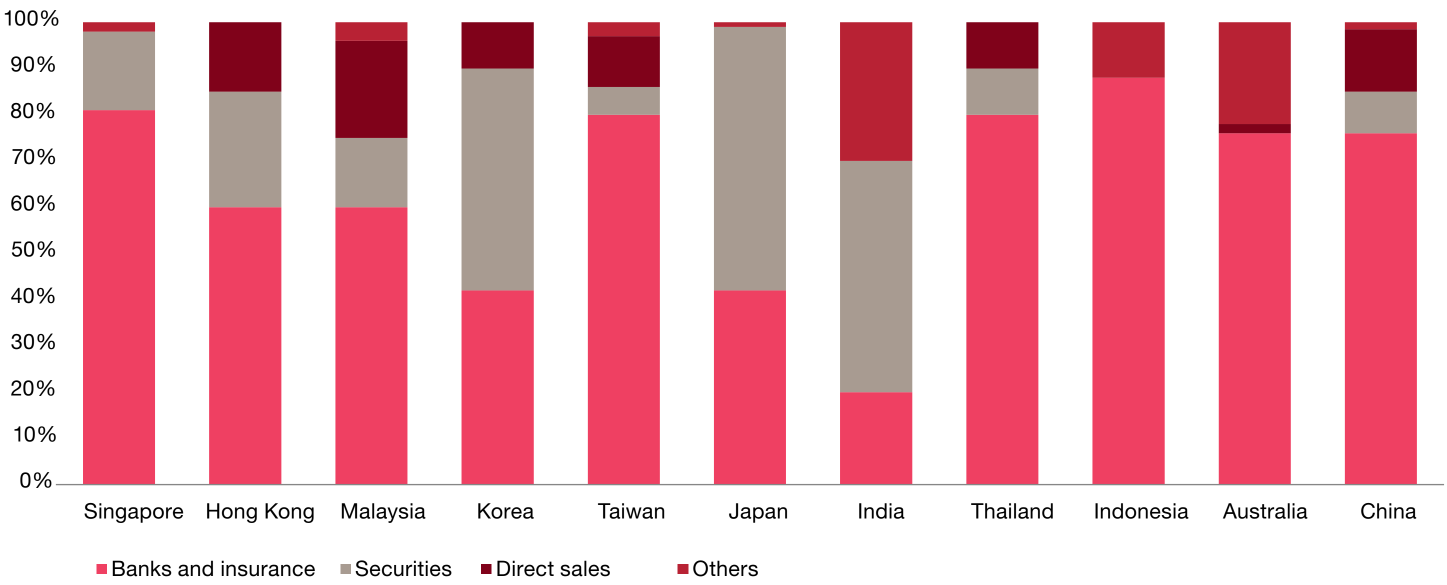
The recently conducted RDR by the Financial Services Authority in the UK prove to be a good case study. They are seeking precisely to address the issue of allowing investors to judge the quality and quantity of advisory services they receive to agree compensation with the distributor. The distributors themselves will need to be well-equipped with all the analytical and risk-assessment tools to enable them to render quality advice.

Structuring the compensation in such a way that the distributor's interests are aligned with the interests of the investor will go a long way towards attuning the distribution of mutual fund products to investor needs.



Another aspect is the channel mix, where India presents a distinct picture. Most Asian peer markets see the lion's share of distribution from banks whereas in India, the banking channel is significantly lower and so is the direct route.

Mutual funds: Distribution channel mix across Asia



Given the wide banking network across the country and the trust people generally have in it, there is a ripe opportunity for banks to distribute mutual fund products. However, the conundrum for front-line staff might be the loss of CASA deposits while gaining distribution fees.

There is reason to debate whether we are missing an opportunity by maintaining a relatively restrictive regime for cross-border sales (in both directions). Europe and several SAAME peers are ahead of the curve.

The digital environment has evolved from providing basic online services to a rich set of capabilities that can empower distributors and drive disruptive changes. Technology will provide some solutions to the distribution process, enabling actions such as the following:

- Leverage or replicate the Banking Correspondents model for IFAs and advisors. Use handheld devices to conduct transactions on real-time basis, with GPRS or CDMA connectivity linking to banking systems, payment gateways and the overall mutual fund transaction ecosystem.
- Leverage the mobile platform by reaching out to mobile network subscribers and collaborating with banks, mobile network operators and payment gateways to provide a secure and sustainable transaction mode for purchases and redemptions.
- Create technology-driven enablers for distributors to help them serve investors in a better fashion.
- Different distributor segments operate in varied patterns in terms of investor engagement. Even within each segment, the individual distributor may have distinct preferences. Detailed knowledge of and engagement with each broker will enable a greater control over sales management for fund houses.

Customer relationship management (CRM) systems needs to be used by fund houses not just to track investor relationships, but to also engage with channel partners in a more meaningful and differentiated manner. Enabling the sales force and channel partners with relevant and actionable insights to manage day-to-day activities and sell better to their investors will lead to an increase in the distributor's business with the respective fund house.

With the increasing adoption of smartphones and other mobile devices, the mobile platform has become the de facto platform of choice. The availability of various types of device (such as phablets and devices with large screens) coupled with the increased penetration of mobile data networks translate to an enhanced experience. Usage of mobile and social platforms will be crucial in engaging effectively with the distributor community and building a mobile point-of-sale. Extending the same philosophy to tech-savvy end investors will help build an intimate and direct relationship with the investor, providing the distributor orfund house with a chance to target investors with extremely relevant marketing communications.

Fund houses can, in turn, leverage advanced analytics and big data collected from structured transactional data from R&Ts and other sources, as well as unstructured data from social media and other platforms to extract meaningful information on investor or distributor behaviour and use this information for more effective targeting of their respective investor groups. Analytic techniques can be used to cross-sell orup-sell products and increase each investor's stake, among other applications.

All in all, there is a high correlation between digital engagement and share-of-wallet, with digitally active customers tending to have a higher product holding. With increasing competition among fund houses, the winning player must focus on increasing its digital engagement with the investor and distributor community.

Regulatory updates

Long-term policy on mutual funds

The Securities and Exchange Board of India (SEBI) has framed a long-term policy[1] for mutual funds. The policy covers aspects including enhancing the reach of mutual fund products, promoting financial inclusion, tax treatment, obligation of various stakeholders, increasing transparency, etc. Its recommendations have been separated into non-tax proposals and tax-related proposals. Most of the non-tax proposals have been notified by the SEBI by way of circulars or notifications. The salient features of the policy are as follows:

Non-tax incentive amendments and proposals

Increase in net worth requirement to 500 million INR

The SEBI has recently notified regulations[2] enhancing the net worth requirement of asset management companies (AMCs) from 100 million INR to 500 million INR. AMCs have been provided a period of three years to comply with the increased net worth requirement. They shall be permitted to launch new schemes only after they comply with the new net-worth requirement.

For AMCs eligible to launch only infrastructure debt schemes, the minimum net- worth requirement has been retained at 100 million INR.

Introduction of the concept of 'seed capital'

- The sponsor or the AMC is now required to invest at least 1% or 5 million INR, whichever is less, (in new open-ended fund offerings) of the amount raised in the growth option. Furthermore, such investments cannot be redeemed until the scheme is wound up.
- For existing open-ended schemes, the sponsor or the AMC needs to comply with the above stipulation within a period of one year.

Disclosures of assets under management (AuM)

In order to enhance transparency and increase the quality of the disclosures for investors, mutual funds are required to disclose on their websites, on a monthly basis, different types of AuMs, and also to share these with the Association of Mutual Funds of India (AMFI).

Disclosure of votes cast by mutual funds

To improve transparency and to encourage mutual funds, AMCs will be required to diligently exercise their voting rights:

- Record and disclose the specific reasons supporting the voting decision with respect to each voting proposal.
- Disclose these reasons on their websites (on a quarterly basis) and in their annual report.
- To obtain voting reports certified by the auditors on an annual basis. The board of directors of the AMC and the trustees of the mutual fund shall be required to review and ensure that the AMCs have voted on important decisions that may affect the interest of the investors, and that the rationale recorded for the voting decision is prudent and adequate.

Financial inclusion

Towards the aspect of financial inclusion, the SEBI vide its circular[3] requires mutual funds to ensure the following:

- Mandatorily make available printed literature on mutual funds in regional languages to ensure investor awareness and education.

1. SEBI Board Meeting dated 13 February 2014
2. SEBI(mutual funds) (amendment) Regulations, 2014, dated 6 May 2014
3. Circular No. CIR/IMD/DF/05/2014 dated 24 March 2014

- Introduce investor awareness campaign in regional languages, both in print and electronic media.

Developing alternative distribution channels

In order to achieve participation from all parts of the country in the mutual fund industry, a need to develop distribution channels has been recognised by the SEBI, as follows:

- Distribution through public sector banks: In order to leverage the wide network and the distribution reach of public sector banks in India, AMCs need to develop a system to provide active support to these banks, which will in turn encourage them to distribute mutual funds products across India.
- Online distribution: In order to target the younger generation and internet savvy users, the mutual funds need to enhance the online investment facility for the distribution of its products.
- Investments by Employees' Provident Fund Organisation (EPFO) in equities and mutual funds.
- The SEBI has proposed that the EPFO should be allowed to invest up to 15% of their corpus in equities and mutual fund products. Furthermore, members of EPFO, earning more than 6,500 INR per month should be offered the option of investing a part of their corpus in mutual fund products of their choice.
- Investments by Navratna and Miniratna Central Public Sector Enterprises (CPSE) in private section mutual funds.
  Presently, Navratna and Miniratna CPSEs are permitted to invest only in public sector mutual funds regulated by the SEBI. It has been recommended by the SEBI in its board meeting that all CPSEs should be allowed to choose from any of the SEBI registered mutual funds for investing their surplus funds.

Tax incentive proposals

- A long-term product such as a mutual fund linked retirement plan, with an additional tax incentive of 50,000 INR,under 80C of Income-tax Act, 1961 (the Act), may be introduced.
- Alternatively, the limit of section 80C of the Act may be increased from 1,00,000 INR to 2,00,000 INR to make mutual funds products a priority for investors among the different investment avenues. The Rajiv Gandhi Equity Savings Scheme may also be brought under this enhanced limit.
- Akin to mergers or consolidations of companies, the merger orconsolidation of equity mutual funds schemes might not be treated as a transfer and therefore, could be exempted from the purview of capital gains taxation.

Cash investments in mutual funds

In order to enhance the reach of mutual fund products amongst small investors who may not be tax-payers and who may not have permanent account numbers or bank accounts, the SEBI has permitted cash investments in mutual funds up to 20,000 INR, per investor, per mutual fund, per financial year. The SEBI has now vide its circular[4] increased this limit of 20,000 INR to 50,000 INR.

Long-term investors for the purpose of infrastructure debt fund (IDF)

Only certain categories of foreign institutional investors (FIIs) that are defined as long-term investors can invest in IDFs.

The SEBI, vide its circular[5] has expanded the universe of strategic investors investing in IDF mutual funds to include even those regulated foreign feeder funds, which at all times have at least 20% of their AUM held by investors belonging to one or more of the above categories of FIIs.

Update on the foreign portfolio investors (FPI) regime

In its bid to encourage and simplify foreign portfolio investments, the SEBI has recently notified the SEBI (foreign portfolio investors) Regulations, 2014, dated 7 January 2014, which seek to repeal and replace the existing SEBI (foreign institutional investors) Regulations, 1995, and the qualified foreign investor (QFI) framework. The Regulations merge all the existing FIIs, sub-accounts and QFIs into a single class of investors known as FPIs. The process of applying for registration with the SEBI has been done away with, and FPIs need to register themselves with the designated depository participants. The Central Board of Direct Taxes (CBDT) vide its notification[6] has extended the FII taxation regime to FPIs.

Regulations on the anvil

The SEBI has, in the last year, released consultation papers on the following:

- Real estate investments trusts (REIT), released along with draft regulations
- Infrastructure investment trusts (InvITs)
- Research analysts; released along with draft regulations

REITs and InvITs will provide alternative investment avenues and help deepen Indian capital markets. Research analyst regulations are aimed at improving governance and ensuring impartial reporting by research analysts.

Taxation updates

During the year, the CBDT vide its circular[7] issued a clarification regarding the applicability of additional income-tax on income distributed by mutual funds to unit holders. By way of this circular, the CBDT has now clarified that the additional income-tax shall be levied only on the income distributed by way of dividends to the unit holders, and shall not be applicable to the income distributed by way of redemption or repurchase of units and allotment of bonus units.

4. Circular no. CIR/IMD/DF/10/2014 dated 22 May 2014
5. Circular no CIR/IMD/DF/20/2013 dated 29 November 2013
6. CBDT notification no 9/ 2014 dated 22 January 2014
7. CBDT circular no 6/ 2014 dated 11 February 2014

Tax proposals to rejuvenate the mutual fund industry

Taxation of investment products

The manner in which an investment product is taxed has a significant impact on an investment decision. For example, in the US, after tax incentives were announced for 401(k) plans, the plans attracted significant investments from investors thereby providing a boost to the asset management industry. Similarly, the National Pension Scheme (NPS) in India is attracting investors because it offers them the ability to defer tax by investing in NPS. Tax treatment also creates arbitrages amongst investment products. Therefore, the role played by tax policies cannot be under emphasised. This is recognised by the SEBI too in their tax-related proposals, announced as a part of the long-term policy on mutual funds.

Safe harbour for local asset managers

Potential income-tax issues have acted as a deterrent as regards Indian asset managers managing offshore funds. To promote the asset management industry in India, it is imperative to provide tax certainty to investors and to introduce safe harbour rules for local asset managers. The following could be provided in the income-tax statute:-

- Offshore funds should not be regarded as tax resident in India where they are managed by local asset managers;
- Local asset managers should not be construed as constituting a 'business connection' of offshore funds in India.

International updates

The USA

Impact of FATCA on asset management industry

On 17 January 2013, the US Department of the Treasury and the Internal Revenue Service (IRS) issued the Foreign Account Tax Compliance Act (FATCA) regulations. This was enacted to prevent and detect offshore tax evasion by US tax-payers. The FATCA regime imposes substantial new due-diligence requirements on foreign financial institutions (FFIs) in relation to the holders of financial accounts and requires reporting and withholding in certain circumstances. Compliance with the FATCA involves not only understanding what the regulations require, but also what the inter-governmental agreement (IGA) and local laws demand.

The various due dates that must be observed to comply with FATCA have already been prescribed. On 1 July 2014 participating FFIs are expected to have new on-boarding procedures that enable the classification of new customers and investors. Further, FATCA withholding also commences on 1 July 2014 for the payment of US-sourced fixed, determinable, annual, periodical (FDAP) income, subject to certain exceptions.

India has recently been included by the US Treasury on the list of the countries that have reached the IGA in substance, and has agreed in principle to sign Model 1 IGA. If India were to sign Model I IGA, then the financial institutions (including asset managers) in India will be required to undertake reporting to a regulator in India (e.g. Central Board of Direct Taxes), which will then share the information with the US IRS.

Asia

Fund passport

The cross-border selling of collective investment funds (mutual funds or unit trusts) is not allowed in most of the countries in the Asia Pacific region.

To address this and make the distribution of fund products across jurisdictions easier, various governments and asset managers have been discussing the creation of a common platform to allow collective investment funds to be manufactured in one country and sold across multiple countries in the Asia Pacific region. This has led to the emergence of 'fund passporting'. The three 'fund passports' that have been announced in the Asia Pacific region are as follows:

- Mutual fund recognition scheme between China and Hong Kong
- Proposed 'Asia Region Fund Passport' Agreement between Australia, South Korea, Singapore and New Zealand
- Memorandum of understanding between Singapore, Malaysia and Thailand to enable cross-border offering of collective investment schemes

These proposals offer investment managers additional avenues to sell the same product in more than one country.

China

Qualified Domestic Limited Partners Programme

In July 2013, Shanghai launched the Qualified Domestic Limited Partners (QDLP) Programme allowing qualified domestic private Renminbi (RMB) funds to be established in Shanghai to invest in offshore securities markets. Each asset manager approved to participate, will have an individual quota of 50 million USD to exchange the RMB funds raised from Chinese investors for foreign currency, which will be invested in the overseas securities market. Thus, the QDLP programme provides a new channel for overseas asset managers to access Chinese domestic capital, particularly from the Chinese institutional investors and high net-worth individuals. It is anticipated that the total volume and the individual volume for each QDLP fund will increase the future.

Hong Kong and China

Mutual fund recognition

On 29 August 2013, China and Hong Kong signed an agreement that provides for both countries' financial regulators to recognise each other's mutual funds. As far as the asset management sector is concerned, the mutual fund recognition scheme will open up Chinese retail and institutional investors' huge savings pool to Hong Kong and other international asset managers. As such, Hong Kong will be the gateway for international asset managers to tap into the mainland market. This will further promote its standing as an international fund centre as well as a prominent offshore RMB centre. Such a move will inevitably encourage international asset managers to re-examine their presence in Hong Kong and their approach to the mainland.

Japan

Nippon Individual Savings Accounts

Among all the measures taken by the Japanese authorities to incentivise households to invest their assets in the financial market, the Japanese Individual Savings Account (NISA) scheme is expected to provide major opportunities for the asset management industry.

In the retail market segment, NISAs could be the long-awaited catalyst that turns investment trusts into long-term asset-building products for Japan's retail public. The rules essentially prohibit short-term trading. NISAs are designed to induce demographic groups that have historically not been part of the investor class to become long-term investors.

These will provide tax exempt treatment of capital gains and dividend income from listed equities and equity investment trusts held in NISAs. Individuals will be permitted to invest upto 1 million YEN annually in NISAs for 10 years through to 2023. Once an eligible asset is purchased in a NISA, capital gains and dividends from the asset will be exempt from tax for a maximum of five years.

Europe

Alternative investment fund managers directive

The alternative investment fund managers directive (AIFMD) is a European Directive that aims to provide a harmonised regulatory and supervisory framework for the managers of alternative investment funds within the EU. The deadline for the EU member states to transpose the AIFMD into their national laws was July 2013.

The status of AIFMD implementation across the EU member states is detailed below:

Particulars	Countries
Successful to fully implement the AIFMD law was a part of their national law before the ultimate deadline of July 2013	Austria, Croatia, Cyprus, Czech Republic, Denmark, France, Germany, Gibraltar, Ireland, Latvia, Luxembourg, Malta, Slovakia, Sweden, The Netherlands, United Kingdom
Successful to fully implement the AIFMD law as a part of their national law post the deadline of July 2013	Bulgaria, Greece, Hungary
Drafting or an on-going implementation stage; may be implemented soon	Belgium, Estonia, Finland, Italy, Lithuania, Norway, Romania, Spain, Slovenia
Minimal progress	Poland, Portugal

United Kingdom

Buffering money market funds

The European Commission (EC) published a proposed regulation on money market funds (MMF) on 4 September 2013, which forms part of the EC's response to the ongoing global debate on shadow banking. This new regulation will introduce many additional requirements, ranging from risk management to data collection and capital buffers.

Change in tax treatment for distributions by UK-authorised funds

The UK government announced in its 2013 budget that it wanted to increase the attractiveness of the UK as an asset management hub. In view of this, the UK government has published new regulations, effective from 19 December 2013, under which UK-authorised funds are allowed to pay gross interest distributions on units held by non-UK resident investors. However, units held by UK residents are still subject to income tax.

The Netherlands

Commission ban

On 17 December 2013, the Ministry of Finance of the Netherlands published the final text of the 'commission ban' for investment firms. Until now, investors in the Netherlands could pay commission (often done indirectly) to investment advisors, banks or investment managers. However, starting 1 January 2014, investors will now have to directly pay investment service fees. The said ban actually applies to every type of investment service provided to non-professional investors. Hence, these investment firms shall now no longer receive commissions from a third party directly or procure via third parties through investment services to the customer.

Conclusion

Without a doubt, the asset management industry has grown enormously over the last two decades. However, when we introspect certain trends and factors emerge that need to be examined. It is interesting to also observe the large global trends because surely and inexorably they will affect the domestic industry in the medium term. The era of insulation is almost over!

Despite the impressive growth the industry remains hemmed in by constraints within the operating framework.

- Whether we examine the industry from the perspective of GDP or household savings, the share of the industry has remained small and more importantly has not grown as rapidly as was desirable. All other alternatives such as real estate, gold, deposits have consistently outstripped the industry flows. *The industry has not achieved its rightful position in the basket of options confronting an investor; therein lies a huge growth opportunity.*
- As regards investors and investor mix, apart from the adverse statistics regarding the declining trend in folios, etc, the larger picture is that of an opportunity to make a positive change! *The investor mix has also not changed significantly. There is an opportunity to tap into the broad-basing of savings and surpluses across the demographic and regions.*
- In many ways the industry has shaped itself into a mutual fund industry rather than an asset management industry as defined by global peers. There exists an opportunity to offer products that address multiple investor needs. Taking a cue from global trends, not only does there lie an opportunity to tap into management of pension and insurance funds, but also to increase the penetration of products such as ETFs. Additionally, while asset managers in India are the largest Indian asset managers, they are not necessarily the largest managers of Indian assets - tax certainty and a push by the industry can open the doors for turning India an international asset management hub. *There is an opportunity for the mutual fund industry to morph itself into a broader asset management industry. This will bring in additional investors and flows as the product basket will offer a holistic array of products with myriad combinations of risk-reward, attracting different classes of investors. An investor then will likely be offered a product that meets his or her needs at every point in life.*
- The distribution channel also has not been as sharply focussed on the industry's products as they vie to offer products that map to the needs of an investor. The individual advisor has to move to a model where the ownership of the investor is with him or her and the distributor interest are aligned with those of the ultimate investor. *If the industry were to be able to offer an increasingly wider product basket that meets a wider swathe of investor needs, the investors as well as the distribution channel engagement will be enhanced and the increasing volumes will create vibrant returns for all stakeholders.*

About CII

The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the development of India, partnering industry, government, and civil society, 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 in 1895, India's premier business association has over 7200 members, from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 100,000 enterprises from around 242 national and regional sectoral industry bodies.

CII charts change by working closely with government on policy issues, interfacing with thought leaders, and enhancing efficiency, competitiveness and business opportunities for industry through a range of specialized services and strategic global linkages. It also provides a platform for consensus-building and networking on key issues.

Extending its agenda beyond business, CII assists industry to identify and execute corporate citizenship programmes. Partnerships with civil society organisations carry forward corporate initiatives for integrated and inclusive development across diverse domains including affirmative action, healthcare, education, livelihood, diversity management, skill development, empowerment of women, and water, to name a few.

The CII theme of 'Accelerating Growth, Creating Employment' for 2014-15 aims to strengthen a growth process that meets the aspirations of today's India. During the year, CII will specially focus on economic growth, education, skill development, manufacturing, investments, ease of doing business, export competitiveness, legal and regulatory architecture, labour law reforms and entrepreneurship as growth enablers.

With 64 offices, including nine centres of excellence and seven overseas in Australia, China, Egypt, France, Singapore, UK, and USA, as well as institutional partnerships with 312 counterpart organisations in 106 countries, CII serves as a reference point for Indian industry and the international business community.

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