The mutual fund industry in India: growing with regulatory reform

The IGIDR Finance Research Group*
Indira Gandhi Institute of Development Research, Bombay

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1 A brief history of mutual funds and their regulation in India

At the start of the mutual fund industry in the early 1960's, there was one government owned firm, the Unit Trust of India (UTI). Along with several other sectors rest of the financial sector, this industry was liberalised in 1993, opening up to other asset management companies (AMC), resulting in a slew of choices in mutual fund products for the Indian investor. Today, the industry stands at 38 asset management companies that manage Rs. 7.1 trillion (USD 160 billion) of Assets under Management (AUM) raised from around 470 million accounts.

Since the economic liberalisation of the early nineties, mutual funds have been regulated by the securities market regulator, Securities and Exchanges Board of India (SEBI), which was itself a very new regulator in the early nineties. At the time, like all the other parts of the financial sector, the industry was lightly regulated with low levels of transparency about the management of funds. It was only in 1998, after a spectacular episode of market misconduct by the CRB group of companies that there was a sea-change in the regulation and supervision of the mutual fund industry.

The regulator focussed on the production end of the mutual fund industry. This resulted in very high disclosure and transparency of the assets under management and improving the governance of the AMCs, setting it apart from the rest of the fund management industry in India. This path towards greater transparency became the industry norm when UTI, the only AMC that was exempt from full transparency on certain products, developed problems in fulfiling obligations to customers. As part of the government bailout package in 2001, the AMC was broken up into two funds. One had a fixed mandate of winding down upon completing the obligations of the original UTI schemes (primarily US-64) to existing customers. The other was a company where the government was one of other shareholders, that would follow all the regulation of the other mutual fund companies. With this, the mutual fund industry became the only fund management industry in India with a minimal presence of public sector ownership.[1]

Since then, there have continued to be changes in the regulation of mutual funds, but largely driven by developments in the broader securities markets. The rules-driven regulatory framework in India has meant that innovation in the securities markets often drives changes in the rules on how mutual funds can access these innovation in offering new products to their customers. However, regulations governing the fund management process has been more or less stable, albeit conservative.

[1] However, there does remain a certain amount of public sector ownership in the mutual fund industry, primarily through the mutual fund subsidiaries of public sector banks and insurance companies. There is a dominance of large Indian business houses in the mutual fund industry. According to the August 2010 numbers in the CMIE Prowess database, around 24% of the AMCs fall under the category of business groups (including banks like SBI), and these firms managed around 46% of the mutual fund AUM.

The recent changes in regulation that have been the cause of much controversy has been in the area of the distribution of these products, and how the cost of distribution is attributed to the customer. This has been one of the major aspects of regulatory focus on the mutual industry since 2005.

1.1 Regulations pertaining to distribution and costs of mutual funds

There are various expenses incurred in a typical mutual fund product, some of which are listed below:

- Indirect costs - These costs are charged to the scheme and are accounted for in the computation of Net asset value (NAV).
  - Initial issue expense: These costs include sales and distribution fees. e.g. marketing, advertising, registration, printing, bank charges etc pertaining to the new fund offer (NFO).
  - Annual scheme recurring expenses: These are operating charges of the scheme. Includes management and advisory fees (charged by AMC), registrar and transfer agents' fee, marketing and selling costs etc.
- Direct costs - These costs are directly paid by the investors and are over and above NAV. These include:
  - Entry load
  - Exit load
  - Securities transaction tax
  - Income tax

SEBI regulations controls the expenses that can be charged to the customer in two ways: a) setting a list of the expenses that cannot be charged, and b) setting limits on some other expenses. There have been various changes that SEBI has made the to the latter over the last decade. As expected, each of these regulatory changes has engendered a reaction in the behaviour of industry.

Based on the major regulatory changes that have taken place with regards to costs charged by the mutual fund industry, we list the following "regulatory regimes":

- *Pre-2006*: Both open and closed end funds were allowed to charge maximum of 6% as initial issue expense as well as entry and exit loads.[2]

[2] The regulatory limit for loads was 7%. In reality, a fund could charge upto 7% of NAV, provided the repurchase price was not lower than 93% of the sale price.

Recurring expense ratio had the maximum of 2.5% which remained unchanged until 2010. For many mutual funds it has remained a standard entry load of 2.25%. Industry practice was to charge a maximum load of 2.5% on equity funds whereas entry loads on debt funds were virtually non-existent.

- *2006–2008*: From April 2006 onwards till the start of 2008. The features of the change were as follows:
  - Initial issue expenses was only permitted for closed-ended schemes, with a maximum limit at 6% subject to amortisation provisions. This required that any exiting investor should pay up the portion of load chargeable to him when exiting the fund so the existing investors do not bear a disproportionate part of the initial issue expense.
  - Since open ended schemes were not permitted these expenses, they were stipulated to meet all expenses connected with sales and distribution of schemes from the entry load (maximum 6%).
  - Since closed-ended schemes are allowed to charge initial issue expenses, they were not permitted to charge entry load.
- *2008*: In January 2008, initial issue expense (and related amortization) was no longer permitted.

  Mutual fund schemes had to adjust expenses connected with sales and distribution of schemes from the entry load.
- *2009, Phase I*: August 2009, the entry load was removed from all types of mutual fund schemes and exit load was made uniform across all fund categories, subject to a maximum of 1%.
- *2009, Phase II*: November 2009, all mutual funds were made tradeable – both for entry as well as exit – through the stock exchanges trading platform.

Table 1 summarizes the change in costs across open and closed end funds.

Table 1 Maximum charges allowed across open-end and closed-end mutual funds(%)

	Upto Apr06		Apr06-Jan08		Jan08-Aug09		Aug09-Mar2010	
	Open	Close	Open	Close	Open	Close	Open	Close
Initial issue expense	6	6	0	6	0	0	0	0
Entry load	6	6	6	0	6	6	0	0
Exit load	6	6	6	6	6	6	1	1
Expense ratio*	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5

*The values are reported for equity funds. Debt funds could charge upto 2.25% and that actual expenses charged were lower than this limit. For example the expenses charged to a liquid fund is only 0.25%

The most recent regulatory changes to the costs of the mutual fund industry in Table 1 has taken place around an extremely volatile period of the securities market, which make it very difficult to understand with any clarity how the regulation has affected the behaviour of the mutual fund industry. However, Anagol and Kim (2010) is an interesting paper that documents the reaction of the mutual fund industry to the regulatory changes of the "*2006–2008* regime". The paper observes two empirical facts about the closed ended mutual funds in India between the years 1999 and 2009. These are:

1. the *number* of new closed-ended equity funds that were started, and
2. the *funds flows* into new closed-ended equity funds

The paper also compares these two numbers for closed-ended mutual funds between two periods: 1999 − 2006 and 2006 − 2008. The paper documents a dramatic increase in the sheer number of funds from the first period (close to zero) to the next (nearly 47 new funds). This was matched by a commensurate amount of funds that were collected under these funds between the two periods. The authors calculate that allowing closed-end funds to charge amortized fees (which they claim are "plausibly more shrouded" than entry loads) supported the significant proliferation of closed-end funds during the latter period. They also roughly calculate that the Indian investors spent around USD 500 million in fees due to these "shrouded fees".

For illustrative purposes, Table 2 shows how much an investor is likely to earn from investing Rs. 100,000 in either a debt or an equity mutual fund investment under today's mutual fund charges.

A recent analysis of MF investor data Shah *et al.* (2010) documents that the typical investment horizon is short term, ie, less than a year of holding, for a large number of retail participation. Therefore, we consider accumulated amount (and costs paid) on two alternative horizons of investment for the investor when he exits from a generic equity/debt scheme at[3]:

- one year from entry, and
- five years from entry

Costs of 6% on entry would have automatically dropped the initial investment to a maturity value with 10% returns on equity to 94,000 and a redemption amount of 102,366 compared with the 106,587 in the first column above.

Thus, costs can have a significant impact on the returns to the investor, particularly if the investor has a tendency to withdraw by the end of the first year of investment.

[3]The rates of costs used in Table 2 are described in the Appendix.

Table 2 Comparison of transaction costs in equity and debt based Mutual funds

	Equity fund @ r=10%		Long term debt fund @ r=7%	
	1 Year	5 Year	1 Year	5 Year
Initial investment	100,000	100,000	100,000	100,000
Maturity value @ r	110,000	161,051	107,000	140,255.17
Maturity value including expense ratio	107,800	145,577	105,128	128,405
On redemption				
Exit load @ 1%	1,078	0.00	0.00	0.00
STT	135	182	0.00	0.00
DDT	0.00	0.00	0.00	0.00
Total value at redemption	**106,587**	**145,395**	**105,128**	**128,405**
After capital gains tax	**90,120**	**145,395**	**94,299**	**115,179**

1.2 Regulation pertaining to transparency of mutual fund products

Since the 1993 liberalisation and the entry of new AMCs, there has been a spate of product innovation in the mutual fund product space. There has been a new age of retail focus through SIP and ELSS, between April 2006 and January 2008. Today, 41 AMCs offer a total of 918 schemes. This inevitably leads to fairly large overlaps between the features of the schemes offered even by the same AMC, and fairly subtle naunces differentiating one scheme from the other. This would also amplify the effect of "shrouding" that Anagol and Kim (2010) refers to: given the complexity involved in the features of the mutual fund products, SEBI's regulation on MF costs are not readily accessible enough to be useful indicators for investors.

Despite this, there has been little by way of regulation regarding the need for more clarity and transparency on product definition and differentiation.[4]

1.3 Regulation pertaining to transparency of mutual fund product distribution

The two recent and significant regulatory changes, that have been the cause of much controversy, have been:

1. The removal of entry loads on all schemes, and an explicit disclosure of payment of commissions to distributors.

[4] One exception to this rule was when SEBI mandated that the fine print about returns on mutual fund products being subject to market risk, needing to be of a larger font size in marketing hardcopies, and spoken at a lower speed in audio-visual advertisements.

2. Facilitating the process for an investor to change between distributors by eliminating the no objection certificate in December 2009.

Mutual fund products in India are today largely distributed by national and regional distributors, private banks, Independent Financial Advisors (IFAs), public sector banks to a smaller extent, and some distribution takes place directly by the AMCs themselves. Shah *et al.* (2010) attributes distribution as follows:

- Private distributors, both national and regional: 36%,
- Private Banks: 25%,
- IFAs: 29%,
- Public sector banks: 4%,
- Own distribution: 6%

Until the recent changes, there has been little clarity on how much of the fees charged by the AMC has been paid for distribution. However, these regulatory changes both force the investor awareness of the size of the distribution commission as well as faciliate the ease of funds transfer from one product to another, or one AMC to another.

The Shah *et al.* (2010) report documents that since these regulatory changes there has been six time increase in the number of transfer requests and an increase in transfer AuM of nearly 2.5 times higher than previously observed. However, other reports are that they have been accompanied by a drop in the AUM in the mutual fund products.

2 Going forward

The SEBI rationale for regulating such dramatic changes recently for the mutual fund industry has been that lower costs and increased transparency ought to create lower barriers to retail participation. Part of the SEBI rationale for explicit disclosure of distribution commission has been in reaction to the abuse of such practices in other areas of financial fund management in India, at the expense of the investor. Also, SEBI's regulations (to trade MF products on exchange, make transparent distribution costs) seem to be on track with respect to the larger global trend is towards greater transparency. All of these is being done to achieve an increased retail participation in mutual fund products over the medium and long term horizons.

However, increased retail participation is not driven by lower costs of participation alone. An illustrative example from within India is the New Pension System (NPS). The NPS was designed with the explicit aim of providing a transparent and low cost pension product to any citizen in India. While the end system has evolved differently from the original design, the NPS does adhere to being one of the lowest cost fund management systems

available in India. However, the participation in this is very low as of the current time. The largest cause that the market attributes to this low growth is that the NPS design did not explicitly factor in the cost of investor awareness and education about NPS. Thus, cost is probably just one important determinant to increasing the retail participation in the mutual fund industry.

Some of the important issues that come to the fore on the question of how to increase retail participation are:

- One the greatest bottleneck perceived is that of a lack of investor awareness. If this is true, then how can investor awareness about the mutual fund products be improved? In this, what is the role of the (a) regulator and (b) the mutual fund industry to promote this need?

  1. Presently, it is the "distribution agents" that make investors aware of products available in the financial sector, be it mutual funds or others like insurance. However, the services they provide range from high valued financial advisory for high net worth individuals to agents that are only responsible for the collection of cheques from customer for delivery to the AMC. There is no standardisation of the role specification of the distributor. They have no accountability with regards to the services they provide to the investor, or to the AMC. This had led to wide-spread incidence of misselling of products across all financial products, across all countries, where the objective of the sale has been to maximise the revenues from the sale rather than to ensure a match between the needs of the investor and the product offered by the AMC.

     That context raises the following questions:

     - Can the existing set of distributors play a greater role in improving investor awareness towards using mutual fund products (or indeed, any financial product) for financial planning?
     - Can the creation of a financial advisory channel/transition of the existing distribution agents towards financial advisory services be done by the financial companies themselves?
     - What is the role of regulation in the creation of such a channel?
     - Since the financial advisory channel must ideally span different financial products (which currently are under different regulators in India today) what is the optimal regulatory involvement to govern the creation and regulation of the financial advisory channel?

  2. A common feature of all financial products available in India today is that there are very few simple and easy to understand products. This is true for the mutual fund products as well, as can be seen in Table 3.

     Given the limited space of assets based on which mutual fund products can be

Table 3 Number and AUM of active and passive mutual funds

The table lists products that are available from various AMCs in India and their AUM. As elsewhere in the world, at the start of the industry, there were only actively managed funds. From 2000 onwards, there have been some passively managed mutual fund products, mostly on the two popular equity indexes of the two big exchanges, Nifty and Sensex. The latest addition to the "passively managed product universe" are the Gold Exchange Traded Funds (ETFs). It is worth noting that ETFs and index funds have no distribution fees.

	No. of products	Average AUM (Rs. Billion)
Passively managed products		
Index funds	15	7.41
Equity	15	7.41
Debt	0	0
Gold ETF	9	28.50
Actively managed products		
Active funds	918	6573.13
Equity	365	2129.58
Debt	391	3226.25

created, there is perhaps a limit on the risk-return choices that can be offered by various fund managers. Therefore, the differentiation across products comes in the form of either (a) bundled with other financial products like insurance or (b) carries additional optionality of and upon exit. This is typically specified as fine-print on the product specification. The complexity that this introduces in understanding products becomes a serious impediment to customer participation. This is enhanced when the customer base has low investment awareness.

The question that needs to be visited is:

- Why is there so little product simplicity in the mutual fund space, or indeed any financial product space, in India?
- Is there any role for regulation to play in bringing about more simplicity of mutual fund products?

- Another bottleneck is that of better investor access. One easy way to visualise this problem is the minimum amount that is required before an individual investor can save using mutual fund products. What is the role of the (a) regulator and (b) the mutual fund industry to promote access to mutual fund products?

  A couple of issues fall under the question of access:

  1. Account opening procedures – for instance, the recent KYC requirements for the investors can be onerous to the small retail investor.

2. Miniumum size of investment – several products have minimum investment sizes that place them out of the reach of small investors.[5]

Developments like the UIDAI[6] with their target of a comprehensive coverage of the population is in the right direction to reducing barriers to access. Others remain in the domain of the regulator and the AMCs.

- How much of the poor retail participation in mutual funds is caused by the lack of a "level playing field" between different fund management choices available to the Indian investor today?

  The newly created FSDC[7] is one clear agency to resolve these kinds of differences. But in the interim while it is operationalised, what can the SEBI/market participants do to resolve these differences?

- What role can the foreign fund management industry play in this process of developing the fund management industry in India?

  In the past two decades since the start of the economic liberalisation, foreign participation has played a significant role in the development of the finance industry, either through example, or by providing competition to the domestic industry.

  The fund management industry all over the world is going through a series of reforms similar to the Indian industry. This is particularly true in the area of evolving different business models that frontally attack the issues of improving investor awareness and more transparent distribution of products through the development of a range of financial advisory services.

  How can we open up the space of foreign participation in the fund management industry to achieve the objective of better domestic retail participation in mutual fund products?

[5] In contrast, the retail access to buying equity is to the tune of one share. This opens up direct equity ownership to a large fraction of the population. Given that this is likely to be undiversified equity participation, it is not necessarily a healthy way for such investors to save.

[6] Unique Identification Authority of India, `http://www.uidai.gov.in`

[7] Financial Stability and Development Committee, a new entity whose creation was announced in the Budget Speech of 2010, to act as a coordinator across the multiple financial sector regulators in India.

Appendix: Cost features of generic debt and equity mutual fund schemes in India

Table 4 Transaction costs in mutual fund investment

Type of cost	Equity based	Debt based
Entry load	Nil	Nil
Exit load	1% if redeemed before 1 year; nil otherwise	1% if redeemed before 1 year; nil otherwise
Expense ratio	2.50% maximum; 2% is used for computations	2.25% is maximum; 1.75% is used for computations
Taxation		
STT	0.125% on redemption	Nil
Capital gains tax	15% if redeemed at or before 1 year; nil otherwise	10% if redeemed after 1 year; regular tax bracqket otherwise
Dividend distribution tax	Nil	13.84%; NA to LT growth funds
Surcharge and education cess	3% of capital gains tax	3% of capital gains tax

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