Indian Mutual Fund Industry: Evolution and Regulatory Challenges

The Foundation of Independent Financial Advisors (FIFA) is a body representing Advisors/Distributors of Mutual Funds in India commonly known as Independent Financial Advisors (IFAs).

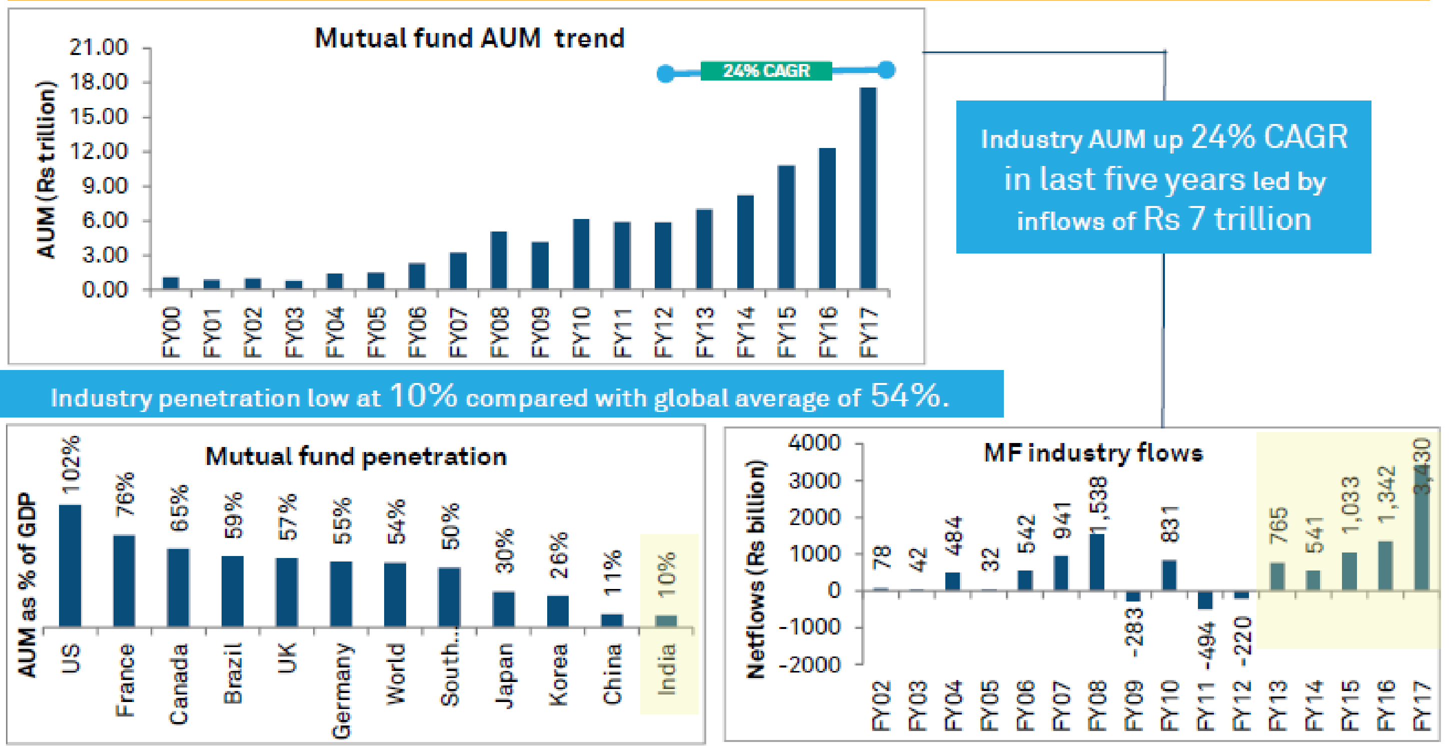
During my recent visit to FECIF, Brussels on behalf of FIFA, I realised the Common Vision that both the associations have for their members, investors and the industry. Financial Intermediation is facing a regulatory backlash globally which is unwarranted.

This article attempts to give a brief overview of the scenario in India. It provides a snapshot of the Indian Mutual Fund Industry and covers its evolution, growth and key industry trends. It also highlights the key regulatory changes introduced by the Indian regulator, the Securities Exchange Board of India (SEBI) post the global meltdown in 2008. A number of regulatory changes introduced ignores the ground realities, especially the move towards banning commissions and moving to a fee based intermediation.

Evolution in India:

The mutual fund industry in India was born in 1964with the government establishing the Unit Trust of India. The Unit Trust of India remained a monopoly till 1987 when other public sector Mutual Funds were allowed to be set up. It was only in 1993 that the private sector was allowed to set up mutual funds.

Phase	**Period**	**AUM Crores**	**AUM CAGR%**	**AUM/ GDP %**	**Regulatory/ Industry Milestones**
1	1964 – **1987**	6,700		2.30%	**1963**: formation of Unit Trust of India (UTI)
2	1987 – **1993**	47,004	38%	6.70%	**1987**: entry of non-UTI, public sector mutual funds
3	1993 – **2004**	1,50,000	11%	5.00%	**1992**: SEBI set up as regulator for securities market **1993**: Entry of private sector funds
4	2004 – **2008**	5,05,152	35%	11.02%	Massive growth period
5	2009 – **2013**	7,01,443	7%	7.47%	**2009**: SEBI removes entry load fee
6	2013 - **present**	20,00,000	26%	10.28%	**2013: Govt/SEBI introduce measures to reenergize mutual fund distribution and penetration**



It took 30 years for the industry to touch an AUM of 50,000 crores. In the next 15 years the size grew 10 times to 500,000 crores by 2008. Over the last 9 years the industry has grown 4 times to cross 2,000,000 crores.

The growth in the last decade can be broken up in further into 2 phases:

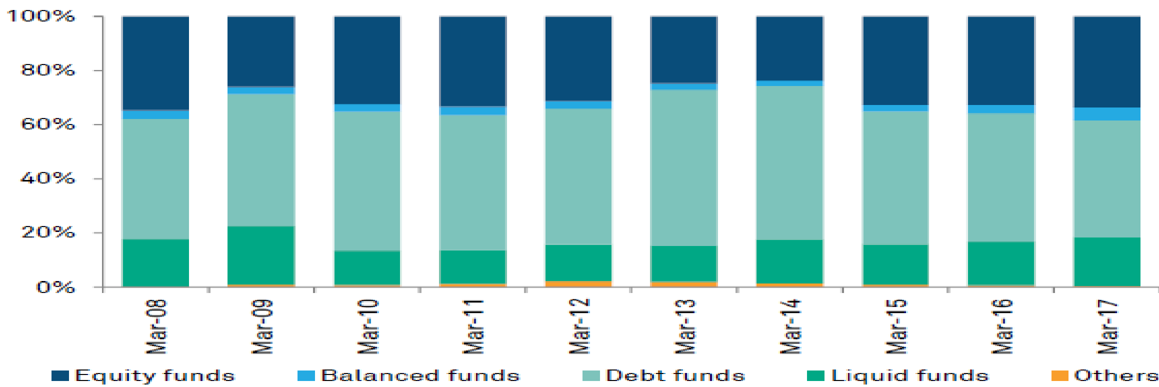
i. The first 5 years from 2008 - 2013 witnessed slow growth with Industry moving from 5 lakh crore to 7 lakh crore growing by 7% p.a. over 5 years. We believe that one of the factors of the slow growth was a result of a dramatic reduction in distribution remuneration by regulations banning entry loads (front load charges) in 2009.

ii. However the next last 4 years has witnessed explosive growth of 25% p.a. with AUM moving from 7 lakh crores to 20 lakh crores. We believe that one of the factors was the increase in distribution incentives for increasing penetration in smaller towns introduced in 2013.

While the Industry has seen significant in the last 5 years, with AUM in India growing at 25% p.a. versus the global industry AUM having grown at a very modest 5% p.a.; India still accounts for less than 1% of the global Mutual Fund Industry. The mutual fund penetration as measured by AUM to GDP ratio is at a low of 10% compared with a global average of 54%.

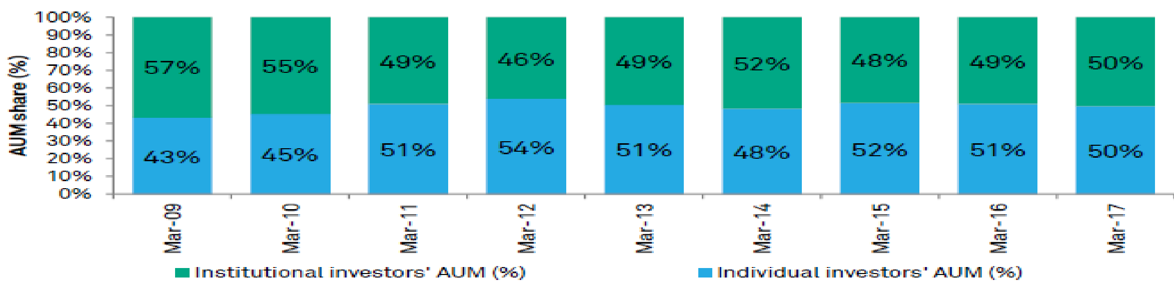
Key Industry Trends in India

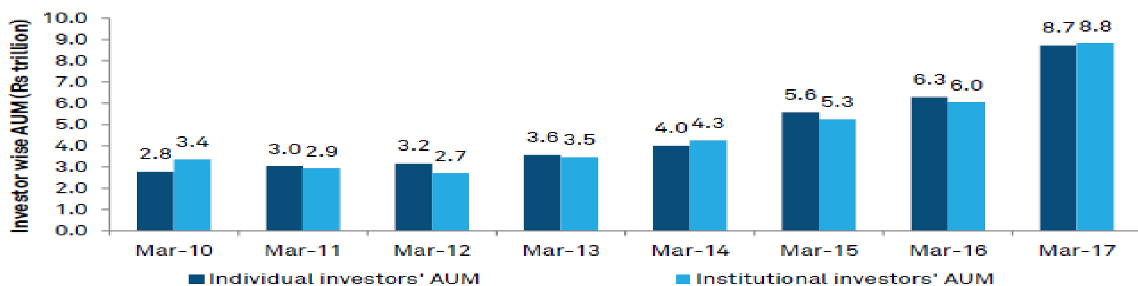
The Indian Mutual Fund industry is tilted towards debt funds (including money market funds) which account for 60% of the total AUM.



Data pertains to month-end AUM
Equity funds also include ELSS and other ETFs
Debt funds also include gilt funds
Others include gold ETFs and fund of funds investing overseas
Source: AMFI

The AUM is contributed equally, 50% by Individual Investors (Retail & HNI) and 50% by Institutional Investors (Corporates Banks , Institutions)

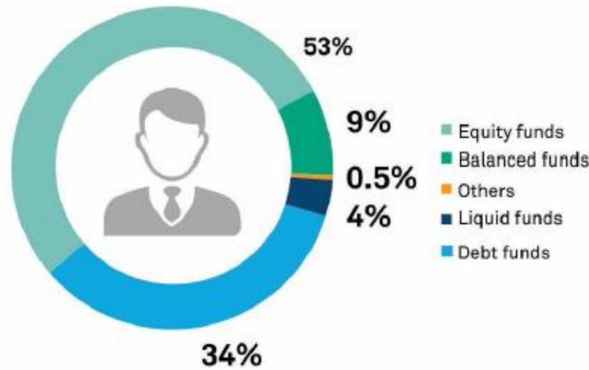




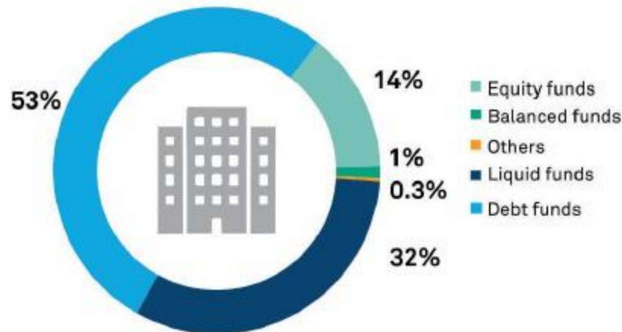
Data pertains to month-end AUM
Source: AMFI

Retail investors prefer equity funds, institutions debt

Individual investors' AUM breakup



Institutional investors' AUM breakup



Equity funds also include ELSS and other ETFs
Debt funds also include gilt funds
Data pertains to month-end AUM as of March 2017
Others include gold ETFs and fund of funds investing overseas
Source: AMFI

Individual investors invest predominantly through an Intermediary while corporates invest directly rather than using an intermediary.

Institutional investors go direct, retail sticks to regular route

Investor-wise composition of direct plans

Investor-wise composition of regular plans

Data pertains to average monthly AUM as of March 2017
Source: AMFI

Excessive and Unwarranted Regulatory backlash:

Post the 2008 global financial meltdown, regulators across the world have been pushing forward a number of regulatory changes aimed at eliminating conflict of interest, providing greater transparency and enhanced disclosures. Unfortunately, what has been lost sight off is that the problems that led to the global financial meltdown was from different segments of the Financial Markets; namely the Housing Mortgage market, Alternative Investments and Excessive Leverage by the large Investment Banks and financial Institutions and not the Mutual Fund Industry.

Even in India, the mutual fund industry emerged relatively unscathed during the global economic crisis and was able to weather the effects of the global meltdown and fulfill all of its obligations to its customers. Despite having no material evidence of any wrong doing by Industry or Mis-Selling by Intermediaries, especially related to Mutual fund Intermediaries, post 2008, SEBI also pushed for a number of significant regulatory changes with a view to micro regulate financial market intermediaries. A few of the major changes are explained below:

(i) Ban on Entry Loads – (Front Load Charges)

In one of the first steps in August 2009, SEBI removed the entry load fee, (front load charges) thereby reducing mutual fund fees (total expense ratio, TER) and the commission payable to distributors. In India, till the ban in August 2009 an entry load of 2.25% was charged to an Investor though regulation allowed a maximum load to be charged up to 5%. The entry load was used to pay upfront commission to the distributor. Most funds waived off loads on Investment amounts above Rs.1 crore. As a result equity fund expenses dropped from approximately 4.25% to 2.00% in their first year of investment. The commission payable to distributors dropped from 2.75% in the first year to 0.5%. India was the only country that abolished entry loads. This led to distributors' income falling by more than 50% and we saw a sharp decline in number of distributors from 2009 to 2013.

(ii) Commission Disclosure

In 2009, regulators introduced a public disclosure of the total aggregate commission earned by a distributor on sales of Mutual Funds in a financial year. Again, maybe the only country and the only profession anywhere to have such a disclosure. It also required disclosure by the distributor of the scheme wise commission he would earn of all competing schemes to the investor.

(iii) Introduced Due Diligence of Distributors

It also required the Asset Management Companies to carry out a Due Diligence to establish that the distributor is " A fit and Proper Person"

(iv) Introduction of a Compulsory Direct Plan

In September 2012, it mandated that every Mutual Fund scheme offer 2 plans:

1) A Regular Plan: For investors who use the services of an advisor/ distributor
2) A Direct Plan: For investors who do not use the services of an advisor/ distributor.

The cost of a direct plan would be lower to the extent of commission paid to distributors in the regular plan. This would have been done to encourage investors to invest directly and reduce the role of distributors/intermediaries.

(v) Consolidation of investment plans

Typically lower cost plans were available for investor with large investment amounts. At that time SEBI consolidated various investment plans available in a mutual fund scheme with different cost structures to make available only one plan per scheme thereby abolishing differential cost structures under a scheme.

(vi) Introduction of a Fee Only Advisory Service

SEBI introduced the Regulations for Investment Advisers in 2013 to usher in a fee only based Investment Advisory Service. The regulations require Investment Advisors meeting minimum qualifications to register with SEBI and charge fees to clients. Such registered Investment Advisers cannot receive any commissions from any product provider.

Exemptions were given in the Investment Adviser regulations to persons giving advice incidental to mutual fund distribution and registered under other regulations, and professionals like Chartered Accountants and Lawyers.

This allowed commission based advisors / distributors to continue offering their services.

(vii) Non-Transmission of Service Tax:

In 2014, the government introduced an indirect tax levy (service tax) on commission earned by mutual fund distributors/ agents. Though the tax was in the nature of an indirect tax, SEBI did not allow an increase in the permissible limits for fund expense ratios thereby not allowing the service tax to be passed on to final consumer (as is the legislative intent) and effectively making distributors bear the tax.

(viii) Cap on upfront brokerage:

SEBI also nudged the Mutual Fund trade body (AMFI) to cap the upfront brokerage payable to distributors and put an embargo on increases in the commissions payable on the existing assets under management.

(ix) Commission disclosures made more stringent:

SEBI further mandated that in addition to the existing disclosures of the aggregate commissions earned by the distributors and the disclosures of the commissions receivable by the distributors at the time of investment by the client, the half yearly Consolidated Account Statements received by the investors would reflect the commission earned by the distributors over every half yearly period at the scheme level.

Mistaken Belief that Fee Based Advice is the only way ahead

According to SEBI and some other global regulators the client engaging with the advisor is in the best position to properly assess the value of that advisor's services and pay him accordingly. They also believe that financial intermediaries remunerated by commissions which are embedded in the cost of the products do not provide the right advice because of conflict of interest. Regulators have an apprehension that the presence of a commission-based fee structure has led financial institutions and intermediaries to focus on maximizing commission incomes at the expense of the investor. World over, regulators have formed an opinion that there is a conflict of interest when an advisor receives commission from the product provider rather than receiving a fee directly from the investor and this has to be eliminated rather than managed.

Thus SEBI and a few other global regulators are considering a ban on commissions and are working towards allowing a fee based service only.

September, 2016 Consultation Paper

In September 2016 SEBI published a consultative paper proposing migration to a Fee Based system from a Commission Based system by banning distributors from giving advice to investors. There was a clear objective to unbundle mutual fund products, and migrate from an embedded, 'commission-based' distribution scheme to a non-embedded, 'fee-based' Intermediation. The paper proposed a time period of 3 years for the intermediaries to compulsory migrate from being commission based advisors/distributors to become fee based advisors.

FIFA was at the forefront in engaging with all stakeholders and making representation on this subject.

Our representations highlighted the likely negative outcomes on a total ban on commission based distribution:

- Advice Gap - Retail investors will be orphaned.
- 0.75% p.a. Increase in Total cost to Investor.
- Dramatic fall in number of Intermediaries
- Hurt retail penetration and financial inclusion

INCREASE IN COST TO INVESTOR

- This is evident from FIFA's study of expense ratios of 25 countries. The findings of this study have been presented to SEBI earlier.
- Based on the above study the average expense ratios are as under :
- Countries with the Fee Model: 2.77%
- Countries with Commission Model: 2.02%
- **Increase in cost to investor 0.75%**

Similar plans to herd and regulate advisors under a single regulatory regime in the UK, the Netherlands, and Australia have witnessed a contraction in the distribution channel and a migration of remaining advisors/distributors towards the wealthier clients.

International Advisory Board

SEBI has an International Advisory Board (IAB) whose role is to guide SEBI and, in doing so, bring in the global experiences and rising developments and challenges. In the meeting of the IAB in January 2017, the IAB recommended that commission- based as well as fee-based approach to investment advisory should co-exist for the time being. The transition from commission to a fee based approach has to be gradual and after a thorough impact analysis. It urged SEBI to study the impact of migration to fee-based advisory models under RDR (retail distribution review), FOFA (future of financial advice) and robo-advisory models.

The compulsory migration of commission based advisors/distributors to become fee based advisors was proposed over a 3 year period was then put on hold.

July 2017 SEBI proposals

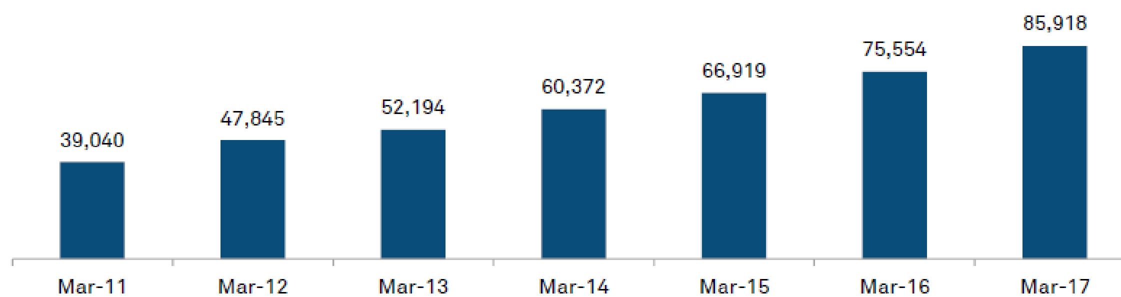
However, in July 2017 SEBI has come out with fresh proposals to separate the advice and sales/execution function. With Fee based advisors entitled to give advice and commission based distributors only sell and execute but not give advice.

Proposed regulations in India ignores ground realities:

These current and proposed regulations ignore the ground realities and the way the advice profession has been structured globally and in India. The investment advisory profession is predominantly a comprehensive service of advice, sales and execution. Execution would include purchase of the appropriate products. It also requires an ongoing service and hand holding. Currently In India and across many countries most intermediaries are remunerated through embedded commissions which are paid out of the cost that investor incurs on his investment rather than paying fees separately.

In India individual intermediaries are known as Independent Financial Advisors (IFAs).

Distribution base in a secular uptrend



Source: AMFI

IFAs are independent of any one product provider. It is essential to understand the dual role that an Independent Financial Advisor (IFA) has been performing. A role which includes an investment process of advice, sales, and service. For his services he is compensated by the product provider from the cost that is charged to the investor.

In India since the introduction of the RIA regulations, only 730 entities have registered, clearly indicating the lack of adoption of the fee-only model in India. Today there are some 86,000 entities registered with AMFI providing advisory services, a majority of them (more than 80000) categorised as Independent Financial Advisors (IFA).

The BCG Report on "Equity Mutual Funds: Charting your Course with a Compass" of June 2010 (BCG Report) indicates that nearly 80 percent of IFAs sell other financial products in addition to mutual funds - for example, life insurance, small savings, general insurance. Most IFAs typically sell mutual funds of five or ten asset management companies (AMCs).

Financial Intermediaries also include the national and regional distributors who typically have a more organized and formal setup compared to IFAs with many of them

having their own branch network, sales force, and online channel. In addition, many of them aggregate some of the sub-brokers' business.

With regard to distribution of the mutual funds, on the customer front, IFAs service 30 to 35 per cent of retail investors, while private and foreign banks service nearly 40 to 45 per cent of the HNI investments. IFAs are dominant in smaller cities and 'retail' segments, whereas banks dominate in top cities and the HNI segment. The other interesting aspect concerned the prevalence of channels of distribution by location and customers. On the location front, not surprisingly, IFAs are much larger in smaller towns. On the customer front, IFAs service 30 to 35 percent of all retail investors (less than 5 lakh), while private and foreign banks service nearly 40 to 45 percent of the HNI investments. Therefore, IFAs play an important role in the retail market.

While the regulation does come with good intent, it fails to understand the ground realities of our country. People in India don't pay for advisory; usually advisory is free. Any conversation with the customer cannot happen without advice. Separating the two would mean that the advisory will either not be done or will be unpaid for.

It would seem that the small number of registrations as Registered Investment Advisors is leading to measures by the regulator to force people to shift. Our concern is that the shift will be negative for the industry at large.

We have submitted a detailed representation to the regulator which is available on our website (www.fifaindia.org) The Mutual Fund penetration in India is very low as opposed to other countries. Financial literacy is one other area where India is lagging behind, and the need of financial intermediation is incontestable.

It is necessary that Regulators world over must evaluate the cost they are imposing on investors on account of perception and fear of Mis-Selling because of conflict of interest. What needs to be acknowledged first and foremost is that the Financial Intermediary enables the investor to achieve his financial goals. Focus has to shift on achieving Investor Outcomes versus mode of Intermediary compensation.

Suggested Framework

To truly empower the investor he must be given the choice to invest on his own or through a Financial Intermediary. Having opted for one he needs to be given the option of how he remunerates the advisor whether by way of fees or embedded commission.

Similarly Advisors must be given the freedom to offer the investor a fee based or an embedded cost based service.

The regulator should not be making these choices or eliminating any of these options. Reducing the available choices to the consumer is never in interest of the consumer in

the long run. The free market system will allow the most efficient model to grow and prosper.

Thus an investor, and the advisor, need to have the freedom to ask for / or offer a service which is either:

a) Fee Based and /or Commission Based
b) Only advise or both Advise and Execution

In India fee based services have failed to take off because the advisor/distributor can offer either a fee based service or an embedded cost/commission based service and most investors are not ready to pay fees separately. Also most clients need a comprehensive service of advice and execution which the current/proposed regulations don't allow.

The proposed regulation requires one to adopt either a fee-based or commission-based service and this is not allowing many existing advisors to change over and accept new fee-only customers. The proposed changes in the consultation paper do not address these issues. For example if an existing commission-based advisor becomes a RIA, he has to stop receiving commissions and start charging fees to investors. He also has to reduce the scope of his work from providing a comprehensive service of advice and execution to only advice.

Existing advisors cannot start with new investors on a fee basis unless they migrate all existing investors. Most investors and advisors are used to and prefer an embedded cost structure versus a fee only model.

Existing Commission based advisors should be allowed to offer Fee Based services rather than becoming Only Fee Based services overnight.

Different investors and advisors will adopt different models, and investor preferences and business viability will lead to growth and co-existence of the different models. We strongly believe that regulations curtailing investor choices are not in the interests of investors.

Common Vision of Advisor Associations

FECIF and FIFA seem to share a common vision, with the interest of the investor being paramount. We both want our members to help their clients achieve their financial goals and well-being. This involves spreading the best practice across the advisor community. While the UK, Australia, and the Netherlands have already banned commissions on the sale of financial products, MIFID 2 has also proposed a ban of Commission for Independent Advisors; Canada is also proposing the same. India has also been considering the same.

Intermediaries play a very critical role especially garnering retail money in financial markets and enabling the investors to achieve their financial goals by preparing financial plans and offering appropriate and suitable products and more importantly hand-holding the investor through the extremely volatile investment journey over a lifetime. Regulators world over should allow a dual role of advisory as well as execution for financial intermediaries and freedom of choice to the investor for the payment of remuneration to them whether by way of commission or by way of fees or both as allowed in USA. The US market is the biggest market in the world and has adopted the above approach. Evidence in UK which banned commissions is a clear warning for regulators not to go that path.

A study undertaken by FIFA of expense ratios across 25 countries across the globe shows that on average an investor in an equity fund in a Fee Based regime incur 0.75% p.a higher cost than the cost incurred by an average investor in a Commission based regime.

We hope regulators across the globe evaluate carefully the likely harmful impact of pushing for a compulsory FEE BASED model instead of one with embedded commissions.

In India we believe SEBI has decided to drop the plan for compulsory migration of Commission based distributors to Fee Based distributors but it has come with a Modified proposal, which proposes segregation of the Advice and Sales/Execution function. Advice by Advisors on a Fee basis with no commissions and sales/ execution on Commission basis.

We find that in Europe MIFID 2 plans to distinguish Advisors as Independent and non-Independent and allow the latter to receive Commissions whilst Independents will have to charge fees. This again would be a disaster for Independent Advisors.

I sense that both FECIF and we have a strong belief that the Regulators have a mistaken belief that a shift to Fee Based intermediation is better than a Commission based model. This is on the mistaken belief that investors are ignorant. While Investors may be financially illiterate it doesn't mean that they cannot make the right choices.

The investor/consumer must be given the right to make a choice. Regulators must allow this freedom to continue. We hope better sense prevails.