

# "CHALLENGES AND ISSUES FACED BY INDIAN MUTUAL FUND INDUSTRY"

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## **ABSTRACT**

The challenges which the mutual fund industry had to face are low customer awareness and financial literacy pose which act as the biggest challenge to channelize the household savings into mutual funds. Further the fund houses have show limited focus on increasing retail penetration and building retail AUM. Most AMC's generally focus on the top 20 cities that is manifested in limited distribution channels and investors servicing. Further multiple regulatory frameworks governs different verticals within the financial service sector, such as different policies pertaining to the pan card requirements, mode of payment, funds management by insurance companies and commission structures, among others. Factors that are impediment to the mutual fund investing are the availability of the large number of mutual fund schemes that makes investment decision complex and difficult, complicated KYC norms that restricts potential investors and quality of advice provided. There is a need for collaborative efforts across all key stakeholders to harness the future growth potential and reach out to the customers.

**Key words:** Mutual fund, Growth Fund, Balanced Fund, Income Funds, Professional Management, Asset Management companies.

## **Introduction**

While the Indian mutual fund industry have grown at an impressive rate during the last few years, the recent developments of the past few months triggered by the global financial crisis have impacted the fortunes of the industry resulting in AUM decline, adversely impacting revenue and profitability. In my study on the "mutual funds industries dynamic environment" has attempted to identify some of the key issues and challenges faced by the industry participants that are preventing the industry from harnessing its true growth potential.

### ❖ Low Levels of Customer Awareness

Low customer awareness levels and financial literacy pose the biggest challenge to channel

ing household savings into mutual funds. IIMS Data works data released in 2007 establishes that low awareness levels among retail investors has a direct bearing on the low mutual fund off take in the retail segment. The general lack of understanding of mutual fund products amongst Indian investors is pervasive in metros and Tier 2 cities alike and majority of them draw little distinction in their approach to investing in mutual funds and direct stock market investments. A large majority of retail investors lack an understanding of risk-return, asset allocation and portfolio diversification concepts.

Low awareness of SIP's in India has resulted in a majority of the customers investing in a lump sum manner. Limited Focus on Increasing Retail Penetration. The Indian mutual fund industry had limited focus on building retail AUM and has only recently stepped up efforts to augment branch presence in Tier 2 and Tier 3 towns. Large ticket size, tax arbitrage available to corporate on investing in money market mutual funds, easy accessibility to institutional customers concentrated in Tier 1 cities are the factors instrumental in mutual fund houses focusing on the institutional segment. Building retail AUM requires significant distribution capability and a wide footprint to be able to penetrate into Tier 2 and Tier 3 towns, which AMC's have recently started focusing on. Institutional AUM, however, makes the industry vulnerable to the possibility of sudden redemption pressures that impact the fund performance.

### ❖ Limited Focus beyond the Top 20 Cities

The mutual fund industry has continues to have limited penetration beyond the top 20 cities. Cities beyond Top 20 only comprise approximately 10 percent of the industry AUM as per industry practitioners. The retail population residing in Tier 2 and Tier 3 towns, even if aware and willing, are unable to invest in mutual funds owing to limited access to suitable distribution channels and investor servicing. The distribution network of most mutual fund houses is largely focused on the Top 20 cities given the high

cost associated with deeper penetration into Tier 2 and Tier 3 towns. However, some of the mutual fund houses have begun focusing on cities beyond the Top 20 by building their branch presence and strengthening distribution reach through non-branch channels.

❖ **Limited Innovation in Product Offerings**

The Indian mutual fund industry has largely been product-led and not sufficiently customer focused. The popularity of NFO's triggered a proliferation of schemes with a large number of non-differentiated products. The industry has had a limited focus on innovation and new product development, thereby catering to the limited needs of the customer. Products that cater specifically to customer life stage needs such as education, marriage, and housing are yet to find their way in the Indian market. Despite the regulations for Real Estate Mutual Funds (REMF) being introduced in 2008, the market is still awaiting the first REMF launch. Further, relatively nascent product categories viz. multi-manager funds that are among the most popular hybrid funds globally have not grown in India owing to the prevailing taxation structure. The Indian mutual fund industry offers limited investment options viz. capital guarantee products for the Indian investors, a large majority of whom are risk averse. The Indian market is still to witness the launch of green funds, socially responsible investments, fund of hedge funds, enhanced money market funds, renewable and energy/ climate change funds.

❖ **Limited Flexibility in Fees and Pricing Structures**

The fee structure in the Indian mutual fund industry enjoys little flexibility unlike developed markets where the level of management fees depend on a variety of factors such as the investment objective of the fund, fund assets, fund performance, the nature and number of services that a fund offers. While the expenses have continuously risen, the management fee levels have remained stagnant. Distributors are compensated for their services through a fixed charge in the form of entry load and additional fees as considered appropriate by the AMC. Regardless of the quality of advice and service provided, the commission payable by the mutual fund customer to the distributors is fixed.

❖ **Limited Customer Engagement**

Mutual fund distributors have been facing questions on their competence, degree of engagement with customer and the value provided to the customer. In the absence of a framework to regulate distributors, both the distributors and the mutual fund

houses have exhibited limited interest in continuously engaging with customers post closure of sale as the commissions and incentives had been largely in the form of upfront fees from product sales (although trail commissions have also been paid in limited instances regardless of the service rendered). As a result of the limited engagement, there have been rising instances of miss-selling to customers.

❖ **Limited Focus of the Public Sector Network on Distribution of Mutual Funds**

Public sector banks with a large captive customer base, significant reach beyond the Top 20 cities in semi-urban and rural areas, and the potential to build the retail investor base, have so far played a very limited role in mutual funds distribution. The India Post network operating the largest postal network in the world majority of which is in rural areas, is stated to have 250 post offices selling mutual funds of five AMC's only; further most of the post offices selling mutual funds are located in Tier 1 and Tier 2 cities which are already been catered to, by national level and other distributors<sup>24</sup>. India Post with its customer base of 170 million account holders and branch network of over 154,000 branches, doubling the size of all bank branches put together is a formidable channel which has been under utilized to date for mutual fund distribution<sup>25</sup>. The postal network also serves as a means to facilitate inclusive and equitable growth to all regions and social groups by providing them with access to financial products such as mutual funds.

❖ **Multiple Regulatory Frameworks Governing Financial Services Sector Verticals**

The regulatory and compliance requirements vary across verticals within the financial services sector specifically mutual funds, insurance and pension funds each of which are governed by an independent regulatory framework and are competing for the same share of the customer's wallet. The mutual fund industry lacks a level playing field in comparison with other verticals within the financial services sector. The mandatory PAN card requirement for investing in mutual funds is perceived to restrict significant potential of the mutual fund industry in being able to tap small ticket investors from investing in mutual funds. On the other hand, ULIP's which are deemed to be competing products do not have the mandatory PAN requirement.

While the payment for investment into mutual funds can be made only through banking facilities, the purchase of ULIP's can be undertaken through cash. The recently introduced NPS

regulations requiring the AMC's to create a separate legal entity for pension funds management have created an additional cost structure for the mutual fund players. Outsourcing funds management in excess of INR 80 billion by insurance companies is not permitted and thus restricts an additional revenue opportunity for the mutual fund industry. In summary, the challenges and issues faced by the Indian mutual fund industry will need to be addressed at the earliest to ensure long term sustained, profitable growth of the industry.

### **Drivers for Investment in Mutual Funds**

The factors that can incentives potential customers to commence and gradually increase their investment in mutual funds are discussed below:-

- 1) Investment in Mutual Funds is attractive to customers owing to tax benefits

The tax benefits associated with investment in mutual funds is the key drivers for customers. Customers consider mutual funds as a medium of ensuring financial independence and security. Since most mutual fund schemes carry easy liquidity options, customers believe that mutual funds are a avenue of savings thereby eliminating the need for borrowing money in case of financial exigencies. Liquidity for the future is deemed to be of utmost importance in making any investment decision

- 2) Consistency in fund performance and brand equity influence customers to make relevant selection of mutual fund schemes

Customers believe that fund performance is necessary but is not a sufficient condition to drive their selection of mutual fund products. Selection of mutual funds by a customer is a function of both the fund performance and brand equity of the fund house. Customers are of the view that the key differentiator at the time of selection of a fund is the positive outlook on performance even if the numbers do not reveal a spectacular historic performance. The brand equity of a mutual fund includes factors like perception of the brand capability drawn from its performance in other sectors.

- 3) Simplification of Processes to Increase the Quantum of Investments

Customers obtain the requisite confidence in their investment process when distributors explain the concepts and the meaning of key terms used in mutual fund application forms in simple terms. Further, this reinforces confidence in the distributor's capabilities and quality of advice provided that facilitate the decision process for investment in a mutual fund scheme. Customers also expressed the

view that a single common application form could be used for all mutual fund investments across multiple mutual fund houses. Simplifying the process for redemption of funds was also identified as a means for further increasing investments in mutual funds.

### **FUTURE OUTLOOK IN A DYNAMIC ENVIRONMENT**

This section contains the summary of the expected drivers for future growth, expected industry growth projections and overall future outlook across various dimensions - customers, markets, products, distribution channels and distribution framework.

#### ❖ Point of View on the Future Outlook

This section on the "Point of view on the Future Outlook" is based on our discussions with key stakeholders and expected trends in the Indian mutual fund industry, based on the global experiences. Industry AUM is likely to continue to grow in the range of 15 to 25 percent from the period 2010 to 2015. Favorable growth scenario with quick economic revival can be seen in figure 1(attached at the end).In the event of a quick economic revival and positive reinforcement of growth drivers identified, KPMG in India is of the view that the Indian mutual fund industry may grow at the rate of 22-25 percent in the period from 2010 to 2015, resulting in AUM of INR 16,000 to 18,000 billion in 2015.

#### **Key growth drivers for this scenario include:-**

- ❖ Increased retail investor participation with a preference for mutual funds over other asset classes perceived to be more risky. This could result in the fulfillment of growing financial aspirations, enabled by rising disposable incomes and increased financial savings.
- ❖ Innovations in distribution driven by increase in the number of certified IFA's and banks selling mutual funds focusing on Tier 2 and Tier 3 towns so Increase in institutional participation triggered by rising corporate revenues with increased economic activity.

In the Figure 2(attached at the end) event of a relatively slower economic revival resulting in the identified growth drivers not reaching their full potential, KPMG in India is of the view that the Indian mutual fund industry may grow in the range of 15-18 percent in the period from 2010 to 2015.

#### **Key factors driving the growth in spite of the slow revival of the economy include:-**

- ❖ Incremental increase in retail investor participation owing to limited focus beyond Tier 2 towns and limited efforts to draw risk adverse customers of traditional products under the fold

of mutual funds.

- ❖ Tightening of liquidity leading to better yields on instruments liquid funds invest in, thereby driving investments from the institutional investors.

### **Industry Profitability May Reduce Further As Revenue Shrink Operating Costs Escalates**

Industry profitability is expected to gradually reduce as revenues of AMC's shrink due to focus on low margin products to attract risk averse investors, and also as operating costs escalate due to the focus on penetrating retail population beyond Tier 2 cities.

- ❖ Decline in investment management fees is expected as risk averse customers prefer investments in debt products.
- ❖ Increase in distribution costs as players attempt to set up their own branch presence in smaller towns.
- ❖ Existing players are likely to review business strategy and explore exit/ mergers in case of no significant competitive advantage, thereby resulting industry consolidation.
- ❖ Competition is expected to intensify further with the entry of global players who are facing stagnant growth in global markets. This is expected to result in a fall in market shares of the Top 10 players and result in a further squeeze on margins.
- ❖ Co-existence of large players with diversified portfolios and some niche plays expected.
- ◆ Product innovation is expected to be limited
- ❖ High margin products such as equity and select debt products likely to continue to contribute a significant share of industry AUM.
- ❖ Flexibility in product pricing by AMC's expected to be permitted based on the type of services offered.
- ❖ Emerging product categories such as ETF's, Multi manager funds, REMF's, outcome-oriented funds such as principal-protected, tax managed and inflation-indexed funds, expected to have marginal share of AUM in spite of rapid growth.
- ❖ Possibility of introducing mandatory rating for mutual fund products through Rating agencies likely to increase investor confidence
- ❖ Efforts expected to be undertaken for developing a well structured and well managed regulated, debt market which should increase in depth.
- ◆ Market deepening and widening is expected with the objective of increased retail penetration and participation in mutual funds.

### **Retail Segment**

- ❖ Increased focus on growing investor awareness and increasing financial literacy is expected, resulting in an increase in the contribution of the retail segment to the industry AUM in the range of 46-48 percent by 2015, from 36 percent as of 2008 as mentioned earlier.
- ❖ Domestic players expected to tap the overseas markets to grow their AUM through alliances with global players.
- ❖ HNI's and Mass Affluent segments may dominate the retail segment.
- ❖ Average holding period for mutual funds and average ticket size of investments in mutual funds likely to remain unchanged.

#### " Institutional Segment

o Institutional segment likely to witness the emergence of a new category of SME's seeking advice on managing their funds.

#### " Market focus

- o Greater participation expected from Tier 2 cities and Tier 3 towns, including rural centers.
- o Share of top 10 cities in total AUM expected to decline as retail investors from smaller cities, towns and rural areas join the mutual fund fold.

#### ◆ Banks

- ❖ The public sector network of nationalized banks and post offices likely to increase their focus on the distribution of mutual funds.
- ❖ Entry of public sector banks as mutual fund manufacturers expected to increase their focus on mutual fund distribution.
- ❖ Private Banks providing financial advice to HNI's expected to marginally increase their market share.

#### ◆ IFA's

- ❖ IFA's expected to emerge as a dominant channel in a scenario of robust stock market growth, focusing on increasing penetration, and will therefore have to focus on initiatives to develop and support this channel (for example, recruitment and training support).

#### ◆ Other channels

- ❖ India is likely to witness the entry of global fund super-markets enabled by regulatory changes.
- ❖ Cooperative sector though beset with internal administrative issues, likely to emerge as another channel which should be tapped by Mutual Funds.
- ❖ Tapping the large network of NGO's, recognized by local authorities to interact and reach out to the lower middle class and poorer segments of

- ❖ population to increase mutual fund penetration.
- ❖ Distributors likely to explore the possibility of innovations such as a common online platform and the usage of debit and credit cards for transactions.
- ❖ The public sector network of nationalized banks and post offices are likely to increase their focus on the distribution of mutual funds.
- ❖ Entry of public sector banks as mutual fund manufacturers are expected to increase their focus on mutual fund distribution.
- ❖ IFA's are expected to emerge as a dominant channel focused on increasing penetration, and will therefore have to focus on initiatives to develop and support this channel (for example, recruitment and training support).
- ❖ IFA channels are expected to witness growth at a faster pace than banks.
- ❖ Private Banks providing financial advice to HNI's expected to marginally increase their market share.
- ◆ Massive expansion is expected in the mutual fund distribution network
- ❖ The public sector network of nationalized banks and post offices are likely to increase their focus on the distribution of mutual funds.
- ❖ Entry of public sector banks as mutual fund manufacturers are expected to increase their focus on mutual fund distribution.
- ❖ IFA's are expected to emerge as a dominant channel focused on increasing penetration, and will therefore have to focus on initiatives to develop and support this channel (for example, recruitment and training support).
- ❖ IFA channels are expected to witness growth at a faster pace than Banks.
- ❖ Private Banks providing financial advice to HNI's expected to marginally increase their market share.
- ❖ Distributors likely to explore the possibility of innovations such as a common online platform and the usage of debit and credit cards for transactions.
- ❖ AMC's are expected to invest in channel innovation such as Mobile and Internet services. Mobile telephony enabling mobile transactions for the purchase and sale of mutual funds and SMS-based services is expected to revolutionize the industry.
- ◆ The regulatory and compliance framework for mutual funds is likely to get aligned with the frameworks across the financial services spectrum

- ❖ Regulators across Financial services spectrum viz. mutual funds and capital markets, pension, insurance and banking expected to work towards harmonization of policies, with support from industry bodies like the CII and the respective industry associations.
- ❖ Thrust of the regulatory and compliance framework expected to be on enhancing resilience and sustainability, investor protection and good governance going forward.

### **PUBLIC SECTOR THRUST INTO MUTUAL FUND DISTRIBUTION AND FOCUS ON STRENGTHENING PRESENCE BEYOND TIER 2 CITIES**

- ◆ Training of the Public Sector Employee Base
- ❖ Training of employees in the public sector network including India Post, Nationalized Banks, Regional Rural Banks and Cooperative Banks, on sale of mutual funds and basic financial planning concepts through the "Train the Trainer" approach, so that they may be inducted as trainers to support customer awareness campaigns run by NISM and AMFI.
- ◆ Opening Up of the Public Sector Branch Network in Tier 3 and Tier 4 Towns
- ❖ Commence sale of mutual funds through the branch network of India Post, Nationalized Banks, Regional Rural Banks and Cooperative Banks by focusing on Tier 2 and Tier 3 towns initially
- ❖ India Post to sell mutual fund products of all SEBI registered AMC's instead of limiting the customer to five AMC's only as is currently prevalent
- ❖ Boost the presence of Investor Service Centers (ISC's) through R&T Agents in Tier 2 and Tier 3 towns and utilize their presence to promote customer awareness of mutual funds.
- ◆ Focus on Increasing Customer Engagement Pre and Post Completion of the Investment
- ❖ AMC's to focus on growing the IFA channel and encourage them to reach out to and engage with customers on their mutual fund needs on an ongoing basis pre and post completion of their investment
- ❖ AMC's to focus on enhancing the marketing and advisory capabilities of all distributors so that they win the trust and confidence of customers
- ❖ AMC's and distributors to focus on establishing base level financial planning capabilities to facilitate the transition from distribution to 'advice'.

## **STRENGTHENING OF ASSOCIATIONS**

### **Strengthening of AMFI**

- ❖ AMFI to play an active role in bringing all the stakeholders together and evolving a strong vision for the mutual fund industry across all dimensions - inspirational AUM growth and profitability, retail penetration, products and pricing, distribution channels, operations and customer service, enabled by a supporting regulatory framework.
- ❖ Augment the employee base of AMFI so as to support NISM in conducting nation-wide customer awareness campaigns.

### **Development of a Common Online Platform**

- ❖ AMFI to coordinate the roll out of a common online platform for AMC's which will result in increasing reach, reducing distribution costs and making transactions free from operational issues.

### **Facilitating Distributor Education and Mandatory Certification**

- ❖ CII and AMFI to support NISM in the promotion of distributor awareness programs.
- ❖ AMFI to include additional financial planning modules in the distributor certification and make certification valid for a two-year period, thereby necessitating a bi-annual renewal.
- ❖ AMFI to facilitate annual updating of the course curriculum in line with the latest products being adopted by the industry.
- ❖ AMFI to facilitate issue of identity card with distributor certification which should be mandated to be provided to the customer at the time of closing the mutual fund sale.

### **Building an Industry Data Repository**

- ❖ AMFI to build a data warehouse which tracks the financial performance of all AMC's in India across key parameters such as revenue and profitability, and performance of all mutual funds schemes in addition to tracking AUM growth and composition.
- ❖ AMFI to publish data on the financial health of all AMC's in a consolidated manner through the AMFI website.
- ❖ Provide a listing on the AMFI website of all certified distributors who have received AMFI certification and update the list based on certification renewals.

### **Creation of an Association of Distributors**

- ❖ Creation of a SEBI recognized association of distributors of mutual fund products with a clearly defined charter and role.

## **HARMONISATION OF POLICIES ACROSS MULTIPLE REGULATORY FRAMEWORKS IN THE FINANCIAL SERVICE SECTORS**

Constitution of a Steering Committee of Financial Services Regulators under the Ministry of Finance

- ❖ It is proposed that the Government of India should constitute a Steering Committee under the aegis of the Ministry of Finance comprising the Financial Services Regulators for mutual funds and capital markets, pension, insurance, banking and other verticals along with representation from CBDT. The Committee's objective should be defined as achieving harmonization in policies and procedures across multiple regulatory frameworks in the Financial Services Sector.

### **Areas Requiring Harmonization**

- ❖ Outsourcing of funds management by insurance companies to AMC's independent of the assets under management, by removing the threshold of INR 80 billion which exists currently.
- ❖ Allow PSU's to invest larger surpluses in mutual funds and open up investment in private sector and foreign mutual funds.

### **Acceptance and Rollout of the Unique Identification Card**

- ❖ Implementation of the Unique Identification Card as a valid document for KYC. The Government has announced that a Unique Identification Card would be issued to all Citizens (President's speech at the Joint Session of Parliament on 4th June 2009). This should be implemented and the card should be a valid document for KYC.

This will entail undertaking public awareness campaign to make holding of the Unique Identification Card mandatory for all Indian citizens and build the supporting institutional infrastructure to issue these cards at a nominal rate through the public sector network.

The Government of India could facilitate issuance of the Unique Identification Card free of cost to all Indian citizens below a specified income threshold which could be in line with the minimum taxation slab limit.

### **Conclusion**

There is a perceived need to review risk and performance analysis capabilities and governance structures, to meet fiduciary responsibilities and the increasing demand for transparency.

AMC's therefore needed to re-orient their

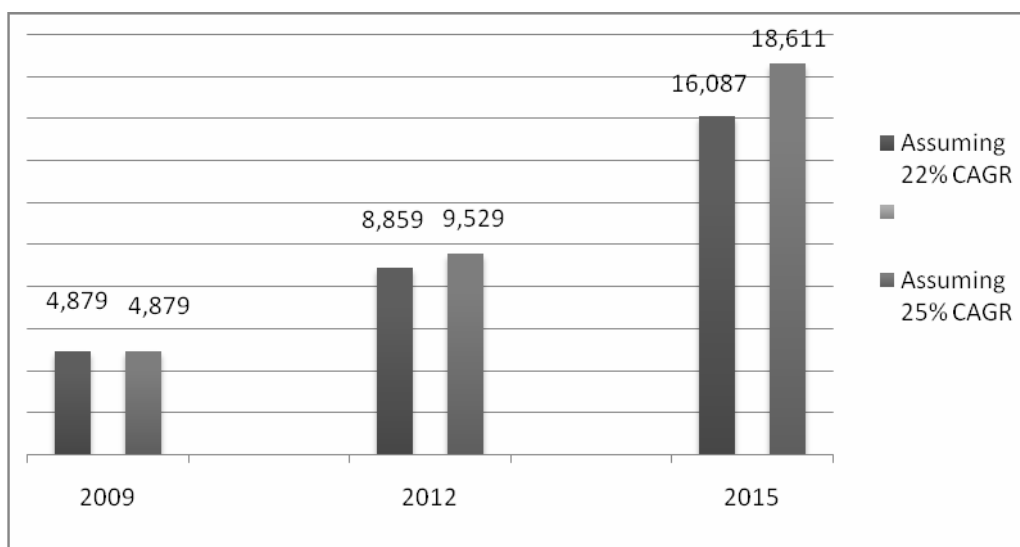
business towards fulfilling customer needs. As customers seek trusted advisors, the manufacturer-distributor-customer relationship is expected to be centered not on the sale of products, but for collectively promoting the financial success of customers across all facets of their professional and personal lives. This requires creating a collaborative network of experts in funds management and financial advice, innovative product offerings, efficient service delivery and supporting technology. The mutual fund industry today needs to develop products to fulfill customer needs and help customers understand how its products cater to their needs.

Given that the industry needs to collectively work towards riding over the dynamic and relatively less favorable economic environment at present, the next phase for the industry is likely to be characterized by a stronger focus on customer centricity. Other areas of focus are likely to be cost management and enabling strong governance and regulatory framework - all aimed at helping the industry achieve sustained, profitable growth, going forward.

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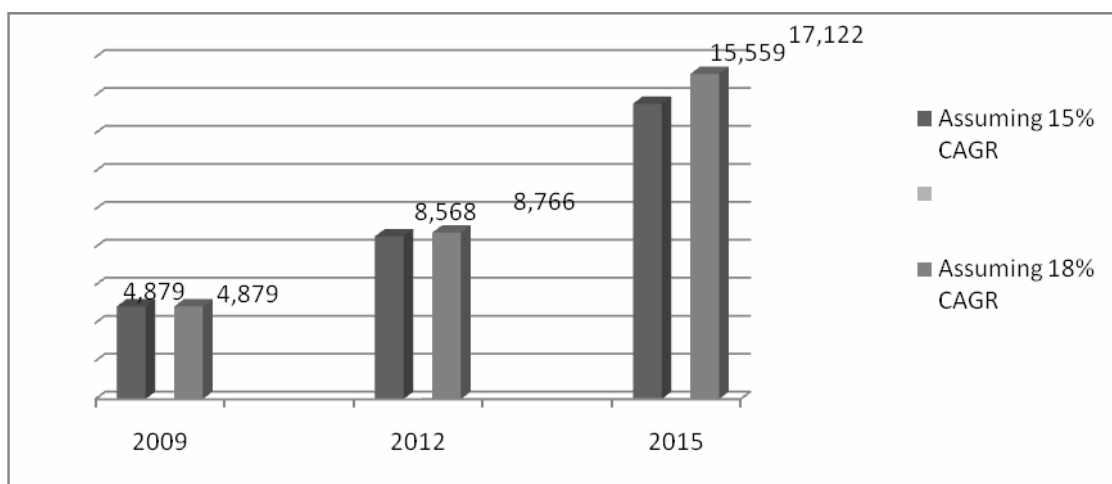
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**Projected AUM Growth from 2010 to 2015**  
**Figure 1: Favorable growth scenario with quick economic revival**



Source :mutualfundindia.com

**Figure 2: Relatively lower growth scenario with slow economic revival**



Source :mutualfundindia.com

**Key words**

Mutual fund: A trust which pools together the money of investors and invests in various schemes of mutual fund.

Growth Fund: Funds which have high risk and return.

Balanced Fund: Funds which have below average risk and return.

Income Funds: Funds which have average risk and return.

Professional Management: Experienced and skilled professionals.

Asset Management companies: Company managing funds.