Distribution of Mutual Funds - Challenges & Opportunities

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The Indian Distribution Industry has undergone several pricing led business model adjustments - right from ban of Mutual Fund entry load in 2009, rationalisation of Insurance Pricing in 2011. Now, capping of Upfront Commissions and move to Trail based model from April 1.

Some talk about an emerging thought process in favour of doing away Distributor Commissions altogether and it is the Investors who should be paying a Fee to their Advisers separately. Philosophically, this is all good but has anyone really asked the investor what he really wants. In UK, there was a survey on Adviser Compensation done a few years ago and at least 3/4 of investors voted that they are happy for their Adviser to be compensated by commissions built into the Financial Product they are buying, be it Life Insurance or Mutual Funds. Very few investors were ready to write a separate cheque for Fees to their Adviser.

Given above insight, Entry load which is paid by investors is the most preferred way to remunerate the Distributor. This system runs successfully in US even today. In some activist regimes like UK where under Retail Distribution Review - all financial product commissions were done away altogether in 2013, the two year report card is dismal. Many Advisers have changed their business model to serve the High Net Worth individuals only or altogether quit business. This has left Retail Investors high and dry underserved or unserved.

Same happened in India in 2009 when Entry loads on Mutual Funds were removed - the number of active Mutual Fund Distributors nosedived from 50,000 to 10,000 leaving a large population of investors unattended. The call centres of Mutual Funds were flooded with service request catching them off guard. The new regime since April 1 may force another half of the remaining Distributors to quit business. The proposed trail model is a good idea from a long term point of view, to align interest of all stakeholders- the investor, manufacturer and the distributor. But any such change has to be smoothly transitioned in over a couple years.

Whenever we plan any change of regime, it is important to know the mind of the consumer, think through the economics of the business and engage in Industry wide consultation and most importantly, give time for transition. It is encouraging to know that the Ministry of Finance high powered Committee on Pricing of Financial Products invited representations from all segments of Distribution. We should conduct a nationwide survey of Investors on what model of Compensation they prefer for their Advisers - Commission based, Fee based, Fee embedded in Financial Product or paid separately by investor. We may be surprised with the results.

Mis-selling by Distributors has been a matter of debate in last few years. Media has blown this concern out of proportion leaving investors confused and making them over cautious. Two recent surveys, one by FIAI (Financial Intermediates Association) and other by DSP Black Rock Mutual Fund bust this myth - in both, some 85% of investors have expressed moderate to high satisfaction for service they get from their Distributor.

There is some element of poor practices in every business and it can be addressed in other ways like Arbitration, Specific action against offenders, Audit and Surveillance mechanism. This has been addressed in an exemplary manner by Stock Exchanges reducing complaints against Stock Brokers from 0.16% to 0.10% over time - Why disrupt the pricing model of entire Industry and bring it back to the drawing board ?

Mis- selling argument gave birth to Direct selling in Mutual Funds. This reflects gross underestimation of the role which responsible distribution plays in the society. Will any Mutual Fund representative ever come and tell you my scheme had stopped performing well, now please shift your money to a competing fund ? We haven't studied the challenges of Mis- buying that would arise in times to come. In Australia, a decade of Direct Selling of Life Insurance has left consumers confused and disillusioned, as no one told them the fine print of exclusions in policy and they didn't get the claims to their surprise. As a result, trust in Life Insurance as a segment dipped and people are now wary of buying Insurance altogether.

SEBI has been innovative in last few years and has come up with progressive reforms like making Mutual Fund fees fungible, introducing additional Fee for expansion of Mutual Fund penetration beyond Top 15 cities, introducing mandatory Investor Education budget and Investment Advisory guidelines. What is needed now is progressive second generation reforms to grow penetration of Mutual Funds from 2% of household savings to 10%. Grow Mutual Fund Equity AUM from Rs 3 lac to 30 lac crores. We need a few million Distributors on street to make this happen. We need some concerted thinking from Government authorities on this. Any Pricing Reforms for Financial Products should take into cognizance that the outcome has to be to create economic incentive to generate more employment in Financial Distribution sector. It is commendable that IRDA is in process of removing cap on Agency commission to expand the Insurance penetration. There is a case for multiple share classes in Mutual Fund commissions also - Upfront only, Trail only, Upfront plus Trail, lower cost Advisory share class available only to registered Investment Advisors (instead of Direct). Create a playing field for multiple models to co-exist and let investors choose what they prefer. This regime runs successfully in US today, as a result a wide breadth of Distribution business models have come and grown. The outcome - penetration of Capital Markets instruments has reached 25% of household savings.

Prime Minister's Jan Dhan Yojna can have a natural extension of bringing more people to Capital Markets and participate in India's Growth Story by starting a Monthly SIP in Mutual Funds for an amount as low as Rs 100. For that we need education and that education can be only provided by a Distributor who is economically viable and a far reaching Distribution system to do the same. This can be another area for Skill India campaign to generate self employment for a million plus youth and get them to help India become a domestic household savings driven economy. Why can't we aspire to raise $100 billion of domestic household savings for national development in next 5 years? The platform has already been laid by the Government through a visionary budget from financial savings perspective by introducing dedicated tax incentives for National Pension Scheme, Gold Monetization, Infrastructure Bonds. Now the only thing left is to create a motivated force of Distributors to create outreach and raise targeted amounts.