Indian Mutual Fund Industry – The road to 5 crore investors

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1. OVERVIEW

1.1. The Indian financial sector passed through one of the worst crisis in 2008. As the financial markets across the world went into recession and FIIs withdrew their interest in the Indian market, the Index went into a tailspin. The month of October 2008, brought the liquidity crisis which affected the banking and the mutual fund industry. In October, due to the pressure on Corporates for liquidity, most corporates started taking their investments out from mutual funds. Some of the Mutual Funds which had invested in papers which were lower than the highest rated papers found it difficult to sell these papers in the market. Therefore to pay back to the investors, some mutual funds had to resort to borrowing, which was difficult due to the liquidity crunch. To bring back liquidity in the mutual funds, the Reserve Bank of India and SEBI had to play a very important role with the RBI opening a special window of liquidity for the mutual funds.

1.2. The recent euphoria in the stock markets can be attributed to the renewed FII interest in India. FIIs have pumped in more than USD 5 billion in this Financial year itself. The FII flow into the Indian markets though welcome is a worrying aspect, as their entry and exit determine the direction of the Indian markets. It is therefore imperative for a country like India to develop the Domestic Investors (DI) market in order to make the Indian markets stable and strong. The Domestic Investors can be the Government, Financial Institutions, Insurance companies and Mutual Funds.

2. THE INDIAN MUTUAL FUND INDUSTRY

2.1. The Indian financial markets for the retail investor can be broadly categorized into 3 segments. The Banking industry for taking care of the short term saving needs, the insurance industry to manage the risk and the mutual fund industry for catering to the investment needs of an individual.

2.2. The Indian mutual fund industry over the last ten years (from 1999 to 2009) has grown at a CAGR of 22%. The growth has been more significant in the last 5 years (from December 2004 – 2008) where it grew at a CAGR of 38% as against the global average of 4%. Only some of the emerging markets like China and Brazil grew faster than India. Despite this, the Indian mutual fund industry is a very small market comprising approximately 0.32% of the global AUM of USD 18.97 trillion as of December 2008 (source: AMFI & ICI).

2.3. Investment in mutual funds comprise of 7.7% of the gross household financial savings in FY 2008 as compared to 1.2% in FY 2004. The ratio of AUM to the country's GDP has gradually increased from 6% in 2003 to 11% in 2009. However this continues to be significantly lower than in developed countries where MF accounts for 25 – 70% of the GDP (source: RBI, KPMG, McKinsey).

3. ISSUES FACED AND THE ROAD MAP TO 5 CRORE INVESTORS

3.1. Mutual Fund industry is passing through the most serious crisis today. While de-growth in 2008-09 can be partially explained by liquidity and market related developments, the threat is more fundamental and structural. Some of the faults can be assigned to the industry itself, but a number of regulatory and tax related provisions have added to the intensity of the problem. While Mutual Funds are getting marginalized, the Insurance industry has grown on the basis of surrogate investment products like ULIP and single premium products.

3.2. To achieve exponential growth, all the stakeholders in the mutual fund industry viz. Government, the Regulators, AMFI, Fund Houses, Intermediaries and the Media need to work together. One can look at the experiences of the telecom industry and the insurance industry to chart out the road map.

3.3. The telecom industry has grown exponentially in the last few years. The subscribers base has increased from 35 lakhs in March 2001 to more than 38 crores in March 2009. The annual growth rate of the sector was 45% in 2007 -08. The growth of the industry can be attributed to the following factors.

3.3.1. **Regulatory role:** The Regulator has been very active and supportive of the industry in making various suggestions to the Government.

3.3.2. **Emphasis on Infrastructure:** The growth of the industry can be attributed directly to the growth in number of towers. The number of towers have continuously increased and are now an estimated 2.74 lakhs.

3.3.3. **Focus on rural sector:** The number of villages covered has gone up from a negligible number in 2003 to an estimated 4 lakh plus villages covering 45 crore population in 2008. This has been due to the Telecom Policy and the Universal Service Obligation Fund (USO) which has helped to widen the reach in rural India.

All telecom operators contribute 5% of their revenues to this fund. Although it increased the cost burden for telecom companies, USO has helped in building the telecommunication infrastructure in rural areas.

3.3.4. **Reducing Tariff:** The tariff has come down from as high as Rs. 16 per minute to Rs. 0.60 per minute today. Again this has been possible because of shift from high cost Licensing fees to a revenue sharing model and the Unified Access Licensing Regime (2003).

3.3.5. **Value Added Services:** The industry has looked at catering to different customers segments and has created specific products for these target segments. Value Added Services (VAS) have played a very important role in this growth. VAS which contributed to a meager 3% of the revenues in 2001 today contribute to 10% of the revenues, with messaging and music being the main contributors.

3.3.6. **New Distribution Channel:** The industry has not limited it sales only through select outlets but has tapped even the smallest outlets like Pan wallahs, medical shops etc for growing their business

3.3.7. **Affordability:** Telecom companies have introduced prepaid recharge for amounts as small as Rs. 10, thus allowing even people from the lowest strata to use a mobile phone.

3.4. Similarly, if one looks at the **Insurance sector**, the industry has grown at a rate of 31.5% CAGR from 2001 to March 2009. The growth of the industry can be attributed to the positive initiatives taken up by the industry like

3.4.1. **Regulator:** The Regulator has taken up issues related to the insurance industry to the Government and has effectively promoted financial inclusion. For e.g. the PAN Card rule was made applicable for only investments above Rs. 50,000.

3.4.2. **Rural Thrust:** To ensure that the benefits of insurance reach to the bottom of the pyramid, IRDA has imposed certain minimum sales targets for sales from rural areas for all insurance companies. This has ensured that companies take efforts to build necessary infrastructure and capabilities to service these customers.

3.4.3. **Product awareness:** The insurance companies have been aggressive in creating product brochures, calculators and other innovative marketing solutions. They have effectively used celebrities as influencers for their products. This has helped build trust and simplify the buy-in process for the customer.

3.4.4. **Creating products as per customer needs:** Even if the insurance industry is accused of mis-selling ULIPs it must be said that Insurance ULIP has been created out of the investors need for higher returns with relatively lower risk. Insurance industry has been proactive at understanding investors needs and creating products suited for that need.

3.4.5. **Creating distribution channel and innovation:** The industry has used the tied agent system to their benefit and ensured that the business is remunerative for the agents. At the same time it has looked at using innovation in distribution by selling through the e-choupal network of ITC.

4. WHAT MUTUAL FUNDS NEED TO DO

4.1. Number of Independent Financial Agents:

4.1.1. The number of insurance agents has exceeded 25.20 lakhs whereas the entire mutual fund industry does not have more than 93,000 agents, half of whom are not working and have migrated to insurance industry.

4.1.2. One of the reasons for this is the high commission structure prevalent in the insurance industry for selling investment products like ULIP, where the agent can earn as high as 25 – 30% commission as compared to the low 2.25 – 3% earned in mutual funds.

4.1.3. With the new SEBI recommendation on 'No Entry Load' for investors and that investors and agents should decide on the commission payable, its impact on the industry will be severe atleast in the short term. This will adversely impact the growth of the industry as even today small investors in small towns go to an Agent or a Post Office to invest and for them maturing to a concept of paying fees will take some time. The Agent will therefore look to push products where he gets direct commission like in insurance. Ideally, there should have been some co-ordination between regulators to ensure that similar rules are in place for similar products. In absence of that, the conclusion that there is a regulatory / policy preference for insurance products over mutual fund products is in-escapable.

4.1.4. The mutual fund industry to survive will have to create a pull for its products in the mind of the investors. It will have to highlight its low cost to the investor as a benefit for better returns as compared to insurance ULIPs. This will lead to higher demand from the investors and will make the agents cater to the investors needs. At the same time fund houses will have to ensure that agents are provided support and training for marketing mutual funds.

4.2. Growth beyond the top cities:

4.2.1. The vast difference in depth of penetration of mutual funds as compared to the banking industry can be seen from the following table.

Rs. in crores

Percentage of Deposits and Assets from Cities for Banks and Mutual Funds	Top 10 Cities	Next 10 Cities	Rest	Total
Bank Fixed Deposits (Dec. 2008)	49.96%	5.46%	44.58%	100%
Mutual Funds AUM (Dec. 2008)	88.20%	4.83%	6.97%	100%

4.2.2. One major drawback which is easily noticeable is that in case of banks and insurance, there are regulatory requirements of expansion of network, coverage of rural areas and promoting inclusiveness, there is no such requirement or impetus for the mutual fund industry. The approach that competition and market forces would automatically lead to a wider spread is not borne out by developments so far.

4.2.3. The Regulator should insist that like in the insurance industry, Mutual Funds should be mandated to get a minimum AUM from the semi urban and rural areas.

4.3. Retail participation:

4.3.1. The Indian mutual fund industry AUM is lopsided in favour of the institutional investor. Retail investors who are 97% of the investors hold only about 37% of the industry AUM as at end of FY 2008. This is significantly lower than retail participation in the US mutual fund industry where the retail investors hold 82% of the AUM. The total number of folios in India are approx. 42 million (the number of investors can be much lower than this as investors hold multiple folios across fund houses), while in US there are around 92 million individual investors. (source: SEBI, KPMG, ICI).

4.3.2. These numbers are directly related to the low customer awareness level about the benefits of investing through mutual funds in the capital markets. The general lack of awareness is similar both in metros and in smaller cities and most people do not make any difference in investing through mutual funds and the stock markets and feel that mutual funds are only about equity. Majority of people do not have detailed understanding of risk return, asset allocation and portfolio diversification and there is hardly any effort to learn the same.

4.3.3. The Mutual fund industry needs to be innovative and should first look at the customer requirements before designing products. There should be simple products which will give investors an alternate to investing in traditionally safe instruments with better returns. The industry should also look to draw a standard form for investment with minimum number of fields for ease of investing.

4.3.4. The industry should also look to leverage on newer technologies like Internet and Mobile phones to effectively push their services.

4.4. Investor Education:

4.4.1. If we believe that dependence on FIIs has to be balanced through a strong growth of domestic institutional investors, then a very active climate of investor education and financial literacy will have to be created. There is an urgent need for a Financial Literacy blueprint and a nationwide programme on Investors education. Instead of different Fund Houses doing their Ad-hoc programmes, the industry should come together and launch a common programme. This should be under the aegis of SEBI. The funding for the same can be done through various measures like using the unclaimed dividend of companies (beyond 7 years) which are notionally being kept in the Investor Education and Protection Fund (IEPF), Penalties recovered from the intermediates by all the Regulators, mutual funds, brokers, insurance companies etc. contributing a portion of their fee income to this fund. The Government should look to form an independent body under SEBI to plan and execute the programmes.

4.4.2. At the secondary or the senior secondary levels at schools, courses in financial literacy may be offered. Right now, NSE and CBSE are offering these courses to selected students as career option in financial market. The idea should be to make the courses more broad-based so as to provide not a career opportunity but for preparing oneself to understand and invest in the markets, whatever career one chooses in future. The contents for the courses can be designed by the industry in consultation with NCERT.

4.5. Regulatory Environment:

4.5.1. Globally, the mutual fund industry has grown on the back of pension assets. But in India neither the old schemes like EPFO nor the NPS have helped growth of the industry. On the contrary, new pressures have been built up on the industry. In the Indian context, the thin line between the activities monitored by different Regulators has been completely obliterated in the last 4/5 years. Pension reforms have brought in PFRDA which has created a new class of fund managers not necessarily linked to the mutual fund industry. Insurance companies which did not have any Unit Linked plan worth the name in 2003, have over the last few years looked for growth only on the back of products that are non traditional Insurance Plans like ULIPs, Single premium products, and guaranteed products. From 2003, the growth has been as under:

	2003-04	2004-05	2005-06	2006-07	2007-08
New Business Premium Linked	Rs.1,674 crs.	Rs.8,531 crs.	Rs.17,368 crs.	Rs.43,059 crs.	Rs.70,603 crs.
Growth		410%	104%	148%	64%

4.5.2. Similarly, ULIPs are also managed by SEBI regulated mutual funds and the rules of the game are entirely different.

4.5.3. The tax treatment given to ULIPs of insurance companies, irrespective of whether the investments are in debt or equity, is totally different to debt products of mutual funds. This kind of beneficial tax treatment has unfavorably helped insurance cos. vis a vis other financial services. In markets where the tax benefits to the insurance cos. have been removed, mutual funds and banks have gained.

4.5.4. Mutual funds therefore needed to be treated on par with ULIPs of insurance companies. This will remove the regulatory arbitrage that is available and will go a long way in helping the mutual funds grow according to its potential.

4.6. Systematic Investment Plans

4.6.1. SIPs are a great way of investing in mutual funds and provide two major benefits. One is that they reduce the entry barrier for the investor as he can start investing monthly with amounts as low as Rs. 500. Secondly, it removes the risk of timing the market and market volatility. Mutual Funds and the Regulators must look at aggressively pushing the SIP numbers. Though progress has been done over the years in terms of growth of the industry SIP accounts, there is great scope for improvement in this area. Also mutual funds should look at lowering their cost structure under SIPs and promote SIPs of smaller amounts like Rs. 100. This will encourage a lot of workers from the rural areas to invest in mutual funds. Mutual funds can look at tie ups with rural cooperative banks and other Cooperative societies where these workers maintain accounts.

4.7. Communication:

4.7.1. It is seen that Mutual Funds are most aggressive in their advertising and communication during boom periods but very silent when the markets are at a low. However, the investor is most worried during these periods of market volatility and wants to hear from the Fund House. Though Mutual Funds cannot ensure that the Net Asset Value (NAV) do not go down, they need to highlight to the investor about the strong processes and systems followed and that all due care is being exercised by the Fund House. These gestures will go a long way in creating trust in the mind of the investor and for remaining invested when the markets tumble.

4.8. Bigger role of PSU Banks and Post Offices:

4.8.1. The Indian Post as well as the PSU Banks have presence across the length and breadth of the Country. Mutual funds looking to set up offices in smaller locations find the cost of setting up their own branch as a big drain on their profits. To reduce the infrastructure costs, the PSU Banks and India Post can offer their space to mutual funds and also help in selling the mutual funds products.

4.8.2. This will help mutual funds reach to the remotest corners of the country and expose to a plethora of new customers.

5. CONCLUSION

5.1. The question that needs to be addressed is whether there is a desire at Government / Regulator / Industry level to reach out to five crore investors and if so then what are the measures required. There are too many inconsistencies in the environment in which the industry is functioning today. There is a small capital requirement, leading to non- serious players in the market with no commitments towards retail penetration or mobilizing the domestic savings for the risk capital. It also leads to trivialization by the Government / Regulators. All the investment products – children plans, ULIPs, Pension Plans can be sold by the insurance industry and under vastly favorable conditions. Assets of insurance companies are prohibited to be managed by AMCs. Tax treatment of mutual funds and insurance products are vastly weighed in favor of the latter. Pension reforms – instead of giving primary role to AMCs are creating a new set of players where any financial sector player can join in. These developments do not augur well for the industry.

The Government, like every other sector like Civil Aviation, Telecom, needs to create a National policy on Mutual Funds. This is important because currently only piece meal changes are being made in the industry. The policy has to clarify the Government stance on mutual funds industry, its role in mobilizing the domestic savings, its role in mobilizing savings from the rural sector, its role in providing old age income security and its role in tax growth. The policy needs to de-lineate the role of different players in the financial sector. The regulatory environment needs to provide enough financial incentives for the industry to grow and then build social or policy commitments into it. Past experiences and the recent initiative of NPS for non Government employees has shown that without financial incentives for both companies and intermediaries even the best models will not succeed to the extent envisaged.

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