14th edition

CII Mutual Fund Summit 2020

SUMMIT WHITEPAPER

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MESSAGE - SUMMIT CHAIRMAN

We are in the midst of interesting times – there are several events especially on the global geo-political front that are likely to shape the next few years if not the decade. We have the ongoing US-China trade war increasing market volatility, upcoming US elections with all its wide-reaching ramifications for global economy, and finally the growing threat of COVID19 with no end in sight.

In India, we are facing the brunt of one of the most serious credit crises of our times. It will take steady and sustained efforts to win back the full confidence of MF investors in debt space. Going forward, Asset Management Companies in particular need to further strengthen their risk management policies to meet the new normal.

Despite ongoing challenges and several obstacles in the last decade as well, the Indian MF Industry has been a shining example of growth in 3 core areas – AUM, investors and overall regulatory environment that both strengthens the Industry and keeps course correcting with new measures.

Indian Asset Management Industry has posted strong growth and caters to over 2 Cr investors. Industry has grown 5 times in last 10 years – with AUM moving from INR 5 lakh Cr to INR ~27 lakh Cr. Post demonetization, Industry assets increased by INR 10 lakh Cr, up 66% in 3+ years, which is a testament to the changing winds resulting in accelerated adoption within the Industry.

In 2012, SEBI allowed additional incentives for selling in B15 areas – since then B15 AUM has multiplied ~7x and proportion has gone up from 15% to 26%. The additional incentive to B15 has been changed to B30 investors to promote participation from Tier 3 and 4 cities. The reach of distributors and fin-tech platforms have contributed a lot towards that end.

Today the sector is expanding and going deeper but there is also strong untapped potential given penetration both in terms of investors and AUM is low as compared to the developed economies.

Though there are number of challenges in the distribution, the situation is changing for better. Today MF has started becoming a household name in small cities and towns as well. MF has started becoming the part of monthly wallet of middle class families which gets reflected by the new SIP enrolments and we are sure that these numbers will grow manifold from here. The growth in SIP flows is happening with a larger backdrop of financialization of savings.

The Indian savers as a whole are increasingly focusing on financial assets in place of physical assets for savings. Gross Financial savings (as % of household assets) are higher than savings in physical assets (including gold). We have observed higher proportion of household assets in MFs – up from 10% to 13% in 2 years.

With the growing maturity of MF Industry, there is also more focus on taking care of small retail investors and minority stakeholders. Industry is increasingly playing active role of stewardship for shareholders – voting has become a lot more involved now and AMCs are engaging with companies on decisions taken.

Despite growth, there is tremendous potential for penetration. We aim for having every Indian family as MF investor in years to come.

This whitepaper features the key discussions points during the 14th CII Mutual Fund Summit, held on Thursday, 27th February 2020 in Mumbai. The aim of this document is to put forward the experience and innovations taken up by asset management companies to progress and challenges they overcame to establish the Indian Asset Management Industry. The document brings together the experience, insights and expectations from the mutual fund ecosystem including the regulator, distribution partners, service providers and even investors. We hope that the whitepaper helps each stakeholder to identify their role in the next phase of chartering growth of the industry.

I would like to thank the summit advisory panel and everyone else who contributed towards this vision document.

PREFACE

Indian Asset Management Market is estimated to grow at a CAGR of approximately 14 % during the period of 2019. India's Asset Management Companies (AMCs) manage (AUM) worth INR 24.46 trillion, out of the total industry assets, around 80% is managed by the top 10 AMCs in the market. Assets managed by the Indian mutual fund industry have grown from INR 23.59 trillion in November 2018 to INR 26.94 trillion in November 2019 (based upon the average assets per month). That represents a 14.21% growth in assets over November 2018. Rising AUM and regulatory effort to lower cost for customers is seen bringing down yield (Total Expense Ratio) on AUM for the industry in the long run. However, growth in AUM with a favourable mix and continued focus on improving operational efficiency makes a case in favour of sustainable growth in earnings. The past few years have witnessed a significant evolution in the asset management industry in India, Individual investors have grown at a significant pace and now command nearly 58% of the AUM. Equity as an asset class has grown in prominence, now accounting for nearly 45% of the AUM as against 23% five years ago. A large share of this shift has been driven by increasing penetration across B15 cities that now account for nearly a quarter of the AUM.

This whitepaper attempts to analyse the evolution and key learnings of the asset management industry in India, understanding the unique requirements of the Indian MF investor and the related responsibility of each stakeholder to serve the end customer and identifying the role of Mutual Funds in channelling household savings into capital markets for robust long-term wealth creation of investors and economy, which may contribute in taking the industry towards the next frontier of growth in the coming few years. The whitepaper also summarizes key imperatives for different industry stakeholders.

The whitepaper has been prepared on the basis of robust analysis and insights from a variety of quantitative sources and qualitative discussions held at the 14th CII Mutual Fund Summit 2020.

The stakeholders' perspective: CII conducted discussions with leading industry participants including senior management of Mutual Fund Companies, AMCs and leading investors to highlight the key industry outlook. About 10 AMC senior management representatives contributed towards key discussions that captured their perspective on the key forces shaping the industry, challenges faced in execution and the contribution of channel partners in extending reach across the country.

EXECUTIVE SUMMARY

Today the Mutual Fund Industry takes a more pivotal and important position for India than we can imagine. It could be attributed to the last decade, which has been a decade of great transformation. After the collapse of USSR, for last 20 years the world has been living with one power, but rapid growth of China between 2000-2010 has supported everyone. US-China competition is critical for Mutual Fund (MF) Industry that can be seen in the following context.

At a very interesting time, the USA has started vacating spaces that China wants to occupy and the multilateral system is getting replaced with bilateral. Unbundling of Europe increases the bargaining power of USA and China wants to have a muscular foreign policy. This situation should be managed properly because in this context the FDIs, Foreign portfolio investments friendly with India at the moment, could be more challenged. Even the private sector banks in India are owned up to 74% by the foreign partners. If there was to be a sanction on India, our system should be in a position to handle such situation.

The mutual fund industry raises money from Indians and hence can be a more stable source of funds. The mutual fund industry need to think of it as an obligation to the nation to become more efficient. How AMC industry get to 100 trillion dollar industry needs to be discussed further. HNIs and individual equity is going up but still the sector has been complacent. What is it that the sector should do to attract more customers, needs to be answered.

The MF industry is restricted to 10-15 cities, to certain target groups and the sector needs to diversify. The sector needs to bring in more customers from different geographies", different age groups and different genders, especially young women from tier two or three cities. To work towards this end the sector needs to strengthen the distribution going forward. The customer experience needs to be reimagined. There is a real need to transform the customer experience from a 'pathetic so far' to a 'great' experience.

Technology and its full use needs to be adapted. Indian technology stack is a shining star. It is really important for the sector to introspect about how do it actually increase the digital interface and use data more effectively to make the experience for customers of a different level. 'How to balance Innovation with Risk' is the challenge everyone is grappling with. There are different dimensions of challenges with advent of fintech coming up with innovation but embodied risks. It is an important challenge and not so easy to navigate. MF as an industry, needs to set high standards of self-governance.

From 1963, when UTI was set up till today the Industry has been through its shares of ups and downs. The soft touch regulation that the sector have, is behind this. On the fronts of 'Investor Protection' and 'orderly development of markets', the regulator has played his role very well. The industry has responded to this positively and has moved forward. The global move from active fund management to passive fund management is definitely a challenge, though India has more reliance on active fund management as of now. People have come to prefer passive fund management and it can be challenging to deal with.

The proactive role played by SEBI in achieving corporate governance or segregation of portfolios or review of investment norms or the risk management framework would not have been possible without suggestions coming from MF Advisory Committee and industry representation. The suggestions and helping hand offered by Industry to the regulator have helped usher in sustainability in the overall system that is going to lead the sector in long term.

On the backdrop of global uncertainty featured in the Brexit or US China trade deal or the general fear of recession, the market conditions are volatile but investors will continue to throng towards the industry in search of alpha. So alpha is going to become an obsession but that cannot be the sole obsessive factor for the industry, there are alternate factors as well.

The discussions around liquidity pressures the industry could face in volatile environment reminds one of the debate whether MFI need be treated at par with banking industry, a banking industry having an SLR and should MFI have a SLR. The recent regulatory nudges have brought in 'liquidity buffers' which the overnight funds and liquid funds need to hold. MFI needs to gauge the liquidity pressures and build up the liquidity buffer by building up a ladder of liquidity maturities. It is going to be a volume based industry and not going to be a margin based industry at all. If the focus is shifted to volume based industry all these changes could be accommodated without much of a problem.

Regulation would come at cost which might appear too stringent at the moment but in future course Industry would absorb the costs comfortably. This is because regulator brings in regulation for a longish timeframe of 10-20 years.

The way forward is to open up new channels, to tap new investor groups to ensure that the industry captures the best of the lot.

Recommendations that came up during the various sessions at the 14th CII Mutual Fund Summit 2020 are mentioned below:

Focus on Household savings for long term wealth creation: This can be achieved by rethinking a fundamental shift in the product proposition. Enhancing investor awareness across all categories of products and simplification of on-boarding processes will be key to target such households.

The need of investing in 'new age customers': Multiple large customer segments with different needs and preferences are expected to emerge over the next decade. The increasing prominence of digital-savvy millennial, the growing influence of women and the rising elderly population are all examples of 'newer' emerging customer segments. The asset management companies will need to rethink the product proposition and go-to-market strategy for these segments given their varying needs and preferences.

Acceleration in distribution outreach: A high touch model will continue to be relevant, especially in B15 cities as first time investors enter the asset management industry. Expanding the network of IFAs/RIAs, better utilization of the banking channel and increasing the utilization of online presence will be key to reach such customers.

Enhancing customer experience: Despite achieving scale and growth, the asset management industry continues to lag in delivering superior customer experience. Complete re-imagination of the customer experience will be required to on-board new customers and engage with existing customers. Investing in mutual fund platforms with simpler "user Interface simplification of the KYC process and automation of the back-end will be vital to deliver on these aspects.

Use of technology across the value chain: Technology can enable asset management companies to target and reach out to a large number of investors with lower costs and improved efficiency to deliver enhanced customer experience without compromising on quality.

Understanding the importance of self-governance: Focus on self-governance will be important as the industry scales up. New age technologies such as data analytics and artificial intelligence can be increasingly leveraged to improve self-governance.

SESSION ONE

Reality Check or learning Curve for Indian Asset Management Industry?

The role of AMCs in corporate debt is critical. Managed assets as a part of corporate debt is still a very small fraction, if one compares the developing as well as developed economies, and this is the part where the country is going to move ahead.

MFs have started playing a role in corporate debt. NBFCs have been a key contributor to credit growth and have been taking over banks as leading finance agencies. However, there has been several instances of crisis emerging with few NBFCs. Even in this crisis, the mutual fund sector continues to outpace the rest of the world in the area and growth. With this backdrop, the below are the reflections and learnings over last 1-2 years -

- IL&FS credit event happened in August 2018 and risk emanated from elsewhere and not from within the business. It has been more because of governance issues, diversity, wilful defaults etc. The learning is not to forget the basics looking at the management, model and the cash flows. One has to actually work around cash flows, governance collaterals as well. As far as the mutual fund industry is concerned, it needs to be more diligent as it is not aware where the risk is going to come from. The mutual funds need to strengthen the legal structure to a very large extent, documentation and make the role of debenture trustees more prominent. Regulators might sound little demanding however it is very much required in the long run for the larger interests of all stakeholders.

- The investor perception today is very dynamic and time to action has become very swift given the market environment. Investor sentiment was hurt since Sept 2018 especially for credit segments. However, extreme paranoia has given way to some sanity and today investors are cautious but hopeful.

- Distributors have played a role in ensuring that the right risks are communicated. This could happen because they shared a responsibility of keeping their reputation and the trust factor intact. So, risk management method infused by distributors and regulatory bodies has helped in communicating the risks.

- The factors like triangulation of internal assessment of credit policies, independent analysis by research team and role of risk team contribute to active communication. The communication around safety and the overall expectation around liquidity safety is important.

- Where investors take risk, it can come in the form of credit and duration. This strategy can give alpha to investors however it comes with its own share of risk. It works in a traditional way, where the investor cannot always expect higher yield by investing in a lower credit rated product. The investment risk involved with low rated products should be communicated more transparently to the end users.

- Though there is lot of distance to be travelled on the customer awareness side, mutual funds as industry needs to take certain steps internally to tighten their processes and overall governance. Segregation is important for the sector. In the absence of segregation, when things turn, the fastest finger first sort of phenomenon leads to that risk suddenly increasing for anyone who stays behind. So those are additional complications that need to be avoided.

In MFI, the role of 'Credit Rating Agencies' is extremely pivotal. A lot gets riding on assessment by these agencies because mutual funds are not structured to evaluate companies in the same way as banks are able to do. It becomes crucial to take into account the lessons learnt by rating agencies from the crisis and also the measures to instil confidence in them. The failures could mainly be attributed to cyclicality or business failures, Governance Issues and issues with structured finance. In reference to frauds, it is seen that every sophistication is being engineered, which highlights the need to upgrade and gather enough market intelligence. One of the final learnings is to develop an understanding of cash flows and get back to basics.

- As MF is yet to realise its full potential in India, defaults are also a reality. To curb the default, the government of India has started to formulize a well strategized documentation process for transparency and communication, which will allow information transfer easier for the engaged parties.

One of the learnings from the crisis is also urgent need to give a push to self-regulation in MFI. Few regulatory reforms like segregated mandate or side pocketing are really important. Categorizing funds so as to have reasonably clear strategies for each category is required. A lot of work has happened around price consistency and discovery and that needs to be pushed forward.

The liquidity crisis is not a structural issue. It is an event manifested by poor governance in certain organizations. The business models are largely intact, and hence the fundamental models of risk-adjusted returns will play out over time.

It is important that the industry focuses on "risk-reward" mechanisms across the value chain. It would require a set of impetus across all stakeholders concerned.

- For manufacturers (AMCs) – Focus back on the basics. AMCs need to build internal capabilities to assess risk better, instead of solely relying on credit agencies. Own due diligence is essential. Many AMCs are bank-backed and can have additional sources of portfolio intelligence. Further, AMCs need to strengthen their legal teams, strengthen the role of debenture trustees and strengthen internal documentation.
    - Further, fund managers should be measured on the right set of metrics to follow risk adjusted returns on portfolios
    - Strict reviews of concentration norms on portfolios should be internally reviewed and adjusted
    - The importance of quartiles while promoting liquid products should be significantly downplayed, as it goes against the objectives of these fund categories since investors are primarily looking at safety and consistency in returns in short term.

- For distributors – Distributors need to ensure that the right risks are communicated. If debt products are being marketed as likely to have improved returns over FDs, it must be appropriately identified that debt portfolios are marred with non-zero credit risk, which may play out. Similar scenarios play out with duration-based products. Risk management by distributors is an important aspect to keep trust alive.

- For credit rating agencies – AMCs have a strong dependence on credit rating agencies, since mutual funds are not structured to evaluate companies in the same way as banks are able to do. A lot of measures have been put in by the regulator on the role of Credit Rating Agencies and the processes they need to follow, however it is equally imperative that Credit Rating Agencies learn from their vast experience, build models that more accurately derive ratings, and have stronger data-backed disclosures. Credit Rating Agencies need to upgrade market intelligence to accurately reflect current macro and player-specific scenarios.

A lot of interventions have been undertaken by regulators, the industry has learnt and emerged stronger. The liquidity crisis necessitates that industry should self-regulate especially on the aspects of customer awareness and education, internal governance and strengthening processes to ensure stronger resilience to such events in the future.

'Getting back to basics - sticking to assessing the risks', 'Higher risks and higher returns' through 'right risk communication' are some of the key takeaways of the session.

SESSION TWO

Demystifying the unique requirements of the Indian MF Investor and the related responsibility of each stakeholder to serve the end customer

There has been a lot of discussion about how the mutual fund industry has grown over the years and more and more investors participated in the Indian economic growth story through mutual funds. There are talks about substantial rise in the systematic investment plan inflows for past couple of years, consistently between Rs 6,000-8,000 crores of monthly flows, which in turn provides substantial domestic flows to capital market. Close to 9 Cr of investors (folios) participating in mutual funds through their investments in various schemes. But a closer look at these statistics reveals that half of the actual composition is in turn debt mutual funds and rest half is equity hybrid or what the sector call as a solution-oriented schemes. There is segmentation of investors in terms of Retail, high net worth individuals and Institutional Investors. The focus is on understanding the requirements as well as unique expectations from the investor community and how could these expectations be addressed by a larger ecosystem represented by the distributors, the manufacturers and the service providers.

- The campaign '*Mutual Fund Sahi Hai'* has helped a lot in Investor education. To take best advantage of this situation there has to be more talk about mutual funds, to create more awareness at customer level and investment advisory as a profession.

- The next phase of a popular campaign like ''*Mutual Fund Sahi Hai'* need to be on the lines of projecting Mutual Fund as a great vehicle for investment. However, the availability of advisors and distributors is missing in the market as a result of which the steam generated awareness created by the campaign has not been tapped to the full extent. The upgraded version of campaign needs to establish that Mutual Fund is good for all categories of investors and have targeted campaign to attract household savings through women investors.

- To accentuate the success of this campaign, there has to a push to '**the feet on street**'. There have to be more advisors for increasing the scale and reach of Mutual Fund. Getting more and more people join profession of 'wealth managers' in Mutual Fund is important. Bright talent in 'consumer reach' and 'financial literacy' should be pushed to tailor new campaigns.

- It is equally important to *'make banking simple again'.* There has to be more thought on how could simplicity be brought to mutual fund investments. On the product side, the regulators have set many norms leaving not much scope for further work but a lot needs to be done on the convenience side. For example, it is indeed necessary to standardize the KYC. In fact, different KYCs from bank and Mutual Fund also leads to technical overheads which could certainly be simplified. *'Jandhan'* led to 29 crore account openings. There could be a *'Janbachat'* account for Mutual Fund on the similar lines, which also has a potential of eliminating KYC technicalities. A 'Common-KYC' could also be a good solution.

- Though too many technicalities and absence of simple processes discourage new Mutual Fund account openings. The further simplification of on boarding process is need of the hour however it should not dilute security aspects and hence larger reliance on technological interventions could be taken into account.

- Ria Money Transfer are there but not in tandem with market. There has to be penetration in rural areas and small towns. Mutual Funds need to reach out to rural areas as alternatives to chit funds and small funds. Also there has to be a parity between treatment meted out to HNI and 'Small Retail Investors'. There has to be more relief for small investors.

- Those in distribution business need to be patient for first few years. The regulators need to allow 'Advisory & Distribution' practice in a controlled, regulated manner.

- Mutual Funds needs to usher in digital foray as well. Non paper transactions are increasing in market, 'on boarding payments and KYC' would start happening sooner while 'physical to digital' transformation is across corner on all fronts of transaction. These interventions are sure to benefit the MFI if accompanied by compliance heavy standards.

- However, though 'Feet on Street' support for executing transaction can be replaced by electronic / digital interventions to full extent, the advisory in 'Feet on Street' cannot be replaced by digital interventions.

SESSION THREE

Role of Mutual Funds in channelling Household Savings into Capital Markets for robust long-term wealth creation of investors and economy

In last few years, financial assets as a percentage of total household assets has gone up from 52% to 61% which is phenomenal but the allocation to mutual fund in financial assets has moved from about 3% to 5% in the same timeframe. This is not in proportion with existing phenomenon and it raises a question. While there is a much larger pool of financial assets available what can the industry do to attract more of that into the mutual fund? How could the performance of the asset management companies as well as the distribution world in channelling funds into the industry be measured and rated by various experts on the panel?

- Out of total savings of any household, 3% to 5% is the allocation into mutual funds and it has gone up from 1%-2%. This is a good method of disciplined investment, not just discipline savings but the industry has so much more road to travel than what it has travelled so far. In other words, the opportunity is still huge and Industry has strong potential to grow. However, on the other side, scheme performance will also play an important role, and it needs to help investors to create more wealth out of their investments as compared to other investment avenues such as bank deposits.

- Mutual Funds is a very young form of investment as compared to investments in fixed assets like real estate and gold. There is a definite shift visible from investments in fixed assets to financial instruments like Mutual Funds.

- Every industry needs time to evolve and mature and so is the case with the mutual fund industry. If the sector is revisited to two and a half years ago, the total number of investors in this industry was around Rs 1.4 crore from where it has gone up to over two crore investors. Effectively with collaborations from different stakeholders including regulator, distributor, manufacturer and other intermediaries, there has been almost 50% jump in investor base.

- When it comes to talking about opportunities in this Industry, the opportunity is immense as large population base is yet to invest into mutual funds. Distributors reached to the HNI and affluent segment first which was quite intensive. The effort to reward ratio was sort of justified. The opportunities are even larger in 'beyond 15' or 'beyond 30' which needs to be tapped by ensuring the right standards and the right disclosures. In this technology will have a large role to play to make this industrialised. The growth rates in the Beyond 30, or in the, the emerging or the mass segment could be 30 to 40% plus, and in the affluent segment can yet be in the high teens to early 20s.

- There has to be larger graduation in smaller towns given the mobile and internet penetration. Technological interventions have made geographical presence of customers irrelevant.

- Factors to propel into small town markets are awareness campaigns and success of SIPs. The wealth generated in new cities is not traditional wealth. In those regions, the wealth generators are young entrepreneurs who can leapfrog from traditional financial assets to MF. This will surely create an opportunity.

- There are number of challenges as well. The way Mutual Fund industry communicates financial products is mainly through English and not through vernacular or local languages. This is a hindrance in reaching to people in 'B15' and'B30'. However, it is very challenging and tough to bring the major technical language associated with financial assets in local languages though many Industry players have started adopting vernacular approach in their marketing materials.

- The Mutual Fund industry does not have enough 'feet on street'. There needs to be more discussion on how should Mutual Fund industry attract more distribution capacity.

- 'Trust-Awareness-Inertia' is a set of challenge every emerging fintech company is bound to face. Technology and app-based learning will help enhance skilling for 'Feet on Street'.

- The present 'Commission Structures' could also be helping or hurting. If split down, the middle, right incentive structures are much required. Compared to Insurance Advisory, Mutual Fund Advisory is not readily available.

- Role of product development is also important in Mutual Fund industry today. Fixed Deposits or Mutual Funds are means to create wealth for end investors.

CONCLUSION

- The CII Summit is being held amidst rising uncertainty and turmoil in the economy at large.
- The ongoing credit crisis in India has also been a downward pressure on Financial Services in India.
- In times like these, all stakeholders of the MF Industry need to come together and further strengthen processes such that the sector go forth from these challenges as an even more resilient Industry.
- Be it global or domestic environment, it is difficult to estimate growth for 2-3 years, however, the Mutual Fund industry remain optimistic of the long-term growth trend of the Indian economy and believe that the Asset Management industry has a great future.
- There are several tailwinds that the Mutual Fund industry enjoys – from the under penetrated potential to Digital growth.
- Digital 'disruption' will play an even larger role in the near future and will help propel the Industry to large masses in Tier 3 / Tier 4 locations for increasing MF adoption.
- Finally, it must be kept in mind that the investor is at the forefront of all Mutual Fund initiatives – because what is good for the investor is good for all stakeholders in the Industry.
- The Mutual Fund industry marches on with the joint goal of bringing Mutual Funds to every single Indian household.

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