



Representation to MFAC on their discussions on Commission Structures

While the bank deposits in the country is around Rs. 88 lakh crores and grew by Rs. 10 lakh crores in the last twelve months, the entire size of the mutual fund industry over the last 50 years of its existence has just crossed 10 lakh crores. And of this, the equity mutual funds have an AUM of only Rs. 3 lakh crores. Indian mutual funds have a very small ownership of hardly 3% of the Rs. 100 lakh crore market capitalisation of the Indian capital markets. This low ownership has severely impacted the country's ability to use domestic risk capital for funding Indian businesses and we have had to rely on overseas funding for building risk capital in the country.

As we all know the costs of doing business in India has increased over the years and this is true for the mutual fund distribution industry as well. In addition to the overall inflation and compliance related costs, the mutual fund distributors have also been impacted by various specific issues over the last few years. Removal of entry loads, and Introduction of Direct Plans have also impacted the financial viability of the industry.

The profit pool in the industry has been in imbalance over the last several years. While much of the mutual fund AMCs are in good profits, most of the distributors, large and small, have been in losses or in marginal profits. As a result, most of the distributors have either scaled down operations or moved out of the mutual fund distribution industry. As per estimates, the industry once had over 60,000 ARN holders selling mutual funds. This number has now dwindled to a paltry active 10,000 ARN holders. The total number of people selling mutual funds in India is around 100,000 (including employees of distributors) whereas the number of life insurance agents is over 10,00,000.

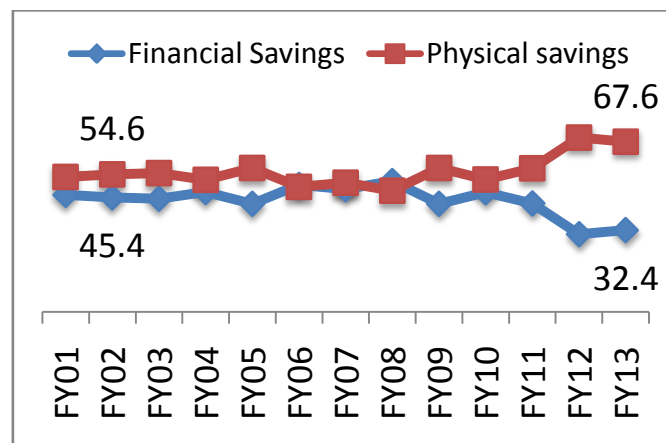
The industry continues to welcome measures to stream line business processes and making the sale process cleaner and more transparent. While these initiatives like KYC, removal of entry loads, direct plans, claw back etc do create a short term impact, both the mutual funds and the distributors have absorbed these initiatives in the long term interest of the industry and have continued to grow the business. The customer complaints ratio in the industry has continuously come down and stands at an all-time low currently.

The distributors view on mutual fund churn

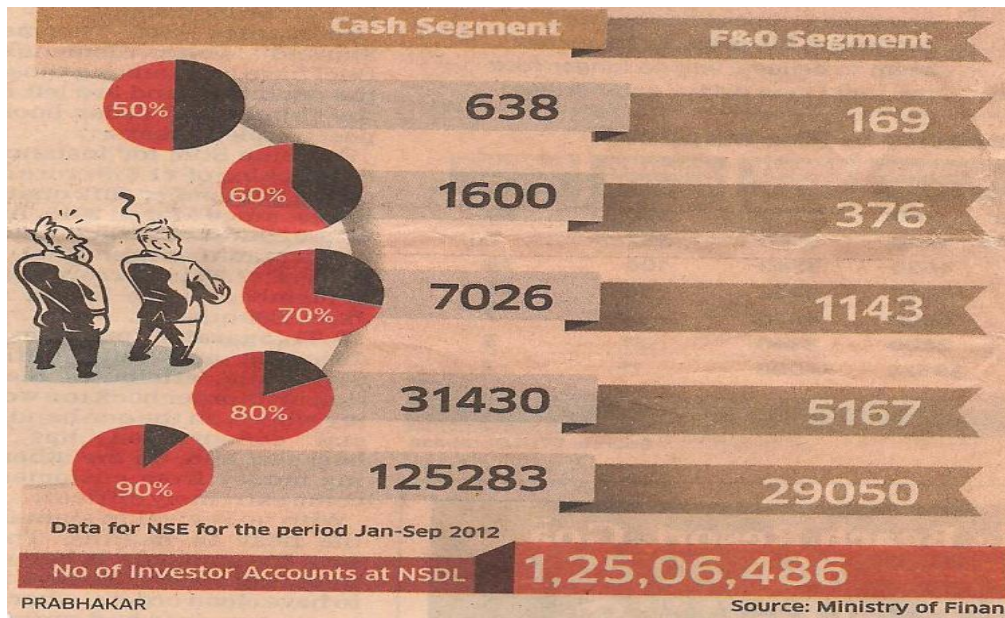
The entire industry is aware that quick redemptions and churn are critical issues for us. We do believe that key to wealth creation is sustained and long term investing by Indians and not short term opportunistic trades. And hence we in the distribution Industry are aligned with the regulator and the mutual funds on this issue. In some situations, we do believe that churn is linked with misselling, although both these are not one and the same. Much of misselling doesn't result in churn and much of the churn is not because of missell or wrong advice. We would like to bring to your kind

attention and some facts and perspectives that may help to drive our point of view on handling the churn.

1. The equity mutual funds are seeing a current average folio life of 3.5 years. And all of us in the industry are committed to keep this high.
2. Over the last few years, when the equity markets were languishing, the phenomenon that we all saw was significant redemptions by investors whenever the markets showed any momentum. Most investors were disenchanted with equities as an asset class and reduced their allocations to all risk based financial investments, including direct equity, insurance and mutual funds. The data below shows how the financial investments as percentage of overall savings dropped over the last few years. So the high redemptions and low gross sales of mutual funds were more a phenomenon of the markets rather than any active missell or churn guidance.



The active investors in India have dropped substantially. Here is a table that was presented by the Ministry of Finance on the active equity investors between January to September 2012. The number is a paltry 125000 unique pan numbers of both institutions and individuals, who contributed to 90% of the exchange volumes, despite India having over 2 crore depository accounts.



3. And if we look at the equity mutual fund redemptions in the last twelve months, we believe that it was the poorly performing schemes of the mutual funds that saw more redemptions than the better performing ones. And this we believe is the right decision by the investors. And the mutual fund schemes will have to ensure better performance if they have to retain their investors. And if some investors have been advised to redeem from poorly performing funds, we believe, this is the right advise and one of the main reasons for existence of the investment advisors.

The Table highlighting the returns of 20 schemes with highest net inflows/outflows over the 12 month period Sept 2013 to Sept 2014 validates the same.

Top 20 Schemes that saw inflows (Rs in Crs)						
Asset Class	AUM As on 30-Sept'14	AUM as on 30-Sept'13	Change in AUM	Factoring 36% market growth in AUM of 30-Sept'13	Net inflow after adjusting market growth	Wt. Average Alpha (Scheme Alpha over Benchmark x Relative Wt. in Top 20 Inflow)
						1 Year 3 years 5 years
Equity (Top 20 Schemes)	74628	36955	37673	50258	24369	25% 9% 8%
Top 20 Schemes that saw outflows (Rs in Crs)						
Asset Class	AUM As on 30-Sept'14	AUM as on 30-Sept'13	Change in AUM	Factoring 36% market growth in AUM of 30-Sept'13	Net inflow after adjusting market growth	Wt. Average Alpha (Scheme Alpha over Benchmark x Relative Wt. in Top 20 outflow)
						1 Year 3 years 5 years
Equity (Bottom 20 Schemes)	40692	36387	4305	49486	-8794	4% 2% 2%

As we can see from the table, schemes with highest net inflows have significantly outperformed their respective benchmarks & those with net outflows have significantly underperformed their respective benchmarks or their peer groups. As distributors, we do not have access to scheme level redemptions etc and hence have had to resort to some ballpark assumptions to arrive at this conclusion. We request a rather involved analysis of data to understand the link between redemptions and performance of mutual fund schemes.

4. Particularly with the HNI investors, who are much more involved and aware of their investment performance, the orientation to shift from poor quality funds to better performing funds is clearly seen and hence the shifting in this category is higher. But even here, it is the investors who have been with the same scheme for over two years where there have been redemptions. The churn is lower in the less than 12 months category, indicating that distributors are advising clients to stay with the funds longer in order to see through its full potential.
5. Hence Flight to quality is emerging as the major reason for the churn, if at all. We firmly believe that the correlation of poor performance to redemptions is far higher than any other reason, including distributors' advice on quick churns. There is a hairline difference between churn and active advice. Distributors are in business because they add value by helping investors choose a better performing scheme over a poor performing one and if necessary by pulling out money from mutual funds. AMCs should strive to improve their investment performance rather than attributing that each instance of investment outflow is churn by the Distributor.
6. With the equity markets improving over the last one year or so, the industry is already seeing better traction. Redemptions have been dropping and new investments are being made in the mutual funds. Even in these months, we did see some investors redeeming their equity funds to invest in other assets classes. But overall, the industry has moved from a 100% Redemption to Gross sale ratio in the last few years to a 50% level in this year.
7. Hence we believe that with the better market performance, churns and misselling complaints will come down, as the primary reason was to do with the fund performance and not with the selling process.
8. In addition, there have been several rules and regulations that have been put in place to reduce churn already. Most mutual funds have now put in a claw back provision in their agreements with distributors. Except for some situations where the mutual funds are working with unreliable distributors, this arrangement becomes a big restraint for a distributor to actively churn customers' portfolio. Many of these rules have already been in place and are working well.

9. However, there are certainly situations of misselling in the nature of fraud we need better management of these complaints like how the NSE Investor Grievance works. NSE's published data shows that the complaints against brokers as a percentage of active investors has dropped to 0.11% in the current year. Under the new distributor SRO, we can also develop a process to address the mutual fund investor complaints and bring the complaints down further.

Upfront and related issues

1. While the overall financial savings in the country has dropped, the share of various financial products in these savings have also changed substantially over the last few years. While Fixed deposits continue to be a sizable portion of financial savings, Insurance remains the second largest and mutual funds remain a distant third. Mutual fund gross sales which used to be as high 2.5 % of the GDP of the country has now dropped to less than 0.5% of our country's GDP. In this context, it is pertinent to note that the Life Insurance premium payments is around 3.9% of GDP in FY 13-14 as per IRDA and they were worried that it has dropped from over 4% levels.

Year	India GDP	Equity Gross Sales	% of GDP
FY08	Rs. 59 lakh cr.	Rs. 1,46,680 cr.	2.5 %
FY14	Rs. 126 lakh cr.	Rs. 57,935 cr.	0.5 %

2. There is an urgent need to bring Indians back into saving into wealth assets that will beat inflation over the long period of time and will provide the retirement cover for them.
3. Retail investors had almost deserted the industry as their returns have been poor over the last many years and their ability to comprehend the many products and their complexities have been rather poor as well.
4. The existing commission structure is a major dampener for any individual to become an advisory or distributor. For instance if an all trail model is to come in force, a person who wishes to become a distributor has to collect Rs. 1.20 crores of equity mutual fund assets in order to receive a top line revenue of Rs. 10,000 per month (@ 1% trail commission per year). At an average ticket size of even Rs. 50,000 per transaction, this means that he has to work with over 240 clients to earn his Rs. 10,000 amonth, that too after the first year. And this is only the revenue. If he has to account for the costs involved in even meeting these 240 clients, that alone will work out to a rather substantial sum and his net earnings will not

be more than 50% of his commissions. On the other hand selling a single policy of Rs. 50,000 premium every month, will give the life insurance agent a commission of Rs. 10,000.

5. The situation is the same for large or small distributors, and as a result, they are unable to build a book and make their business viable. All the distributors have seen a drought of money inflows into mutual funds over the last several years and need help towards recovering their business viability and growth at this time. Any reduction of commissions will directly impact their topline and will further make the businesses more unviable.
6. And any reduction in distributor commissions will not benefit the investors either. As the distributors are paid by AMC's who gets a fixed percentage as expense sharing. The investor will continue to pay the same amount from his fund, irrespective of the change in the commission structure. Hence any reduction in commissions will help only the mutual fund AMC's and will negatively affect the distributor and will make no difference to the investor. An already profitable mutual fund AMC will make more profits and the loss making distributors will make more losses.
7. The focus at this point in time for all of us is to grow and develop the mutual funds industry and help and enable all the participants including the distribution fraternity to have a viable business model. Once the industry grows and mutual fund schemes start getting their performance right, much of these issues of misselling and churn complaints will reduce substantially
8. The only viable space for mutual fund distributor currently is in the high ticket size and any reduction in commissions here will only ensure a very significant disturbance to the business model of distributors. As mentioned before, the customers will not benefit from this move. Only the mutual fund AMC profitability will move up further.
9. On the close ended funds, the mutual funds have started the practice of having front ending of upfront and trail commissions. Moneys collected in these close ended schemes are still limited compared to the overall industry size. While the larger mutual funds find it viable to dip into their deep pockets and provide upfront high commissions, the smaller mutual funds suffer as they are unable to do so. This is a mutual fund AMC's issue. The distribution community did not initiate this process and would welcome a standard process that can work well for all the three entities (large mutual funds, small mutual funds and the distributor) without impacting the customer.

In summary,

1. The capital markets have finally started moving with a hope of growth and development in the country.



2. The mutual fund industry and particularly the distribution community have suffered very badly over the last several years.
3. The time now is to nurture good quality mutual funds and distribution businesses to ensure rapid growth of mutual funds in the country and channelize the much needed risk capital for Indian Industries from the Indian investors.
4. The time now is for the mutual fund AMC's to focus on quality of performance of their mutual fund schemes and ensure that these schemes provide appropriate returns to investors and thereby reduce the need for the investors to constantly look for other opportunities to shift into and churn their portfolios
5. Any further disruption of the distribution model that will further reduce revenues to this sector will be counter productive and will further reduce the mutual fund penetration in the country.
6. Mutual fund distribution fraternity, like the broking and sub-broking fraternity who are recognized and regulated by the stock exchanges and SEBI, should also come under accreditation by SEBI or an SRO at the earliest so that they also become a strong and recognized second peg of mutual fund Industry in the country. The Distribution fraternity is an integral part of the overall mutual fund infrastructure in India and has worked hard to build the mutual fund assets in this country. A formal recognition of this industry will go a long way in building a strong and transparent mutual fund industry.
7. Instead of altering the commercial aspects of distribution, strengthening of the selling processes and investor complaint redressal mechanisms will help in providing confidence to investors. It will be more appropriate to investigate and settle investor complaints case by case and to ensure that both the mutual fund AMC and distributors remain within the overall ambit of responsible selling and providing superior customer service.
8. Hence it is our sincere request that any decision on changing commission structures must be kept in abeyance till the markets settle down at higher performance levels and if such policies have to be decided on then such decisions should be taken after giving due opportunity to the distribution community to be able to present their case.

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