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Building a sustainable independent financial advisor model in India's rapidly changing mutual fund environment

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Abstract

The Indian mutual fund Industry has witnessed a slew of changes initiated by Sebi with a view to protect the individual mutual fund investor since 2009, beginning with the removal of the entry load.The distribution segment has witnessed changes leading to development of new models. The Independent Financial Advisor (IFA) segment in particular has been deeply affected and has seen a substantial decline in the number of active IFAs. This paper traces the development of the IFA model in Indian context, discusses the model adopted by other distribution channels namely Banks currently. The paper further outlines a model for making the IFA segment sustainable. The paper analyses primary data of IFA studies undertaken at two different points of time during the course of the last 3 years and thereby constitutes an exhaustive research work for this segment.

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Keywords: Independent Financial Advisor; Investor Protection; Mutual Funds; Regulation

1. Indian mutual fund industry background

The origin of the Indian mutual fund (MF) industry can be traced to the establishment of UTI as a state monopoly in 1964. Over the years, the industry has evolved in to a high growth and competitive market due to the reforms impetus, economic conditions and favourable demographics. Currently, as per AMFI reports for August 2012, there are 44 Asset Management Companies (AMCs) managing a total AUM of INR 6.4 Trillion.

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Current MF industry scenario & distribution structure**:** As per published data this industry has witnessed a decline of 6.3% and 5.1% in FY11 and FY12. Among the reasons attributed by industry experts are a slew of measures that the regulator SEBI has undertaken since July 2009 directed towards investor protection and transparency of industry operation. Prominent among these include are the removal of entry load, introduction of stringent KYC norms, tightened valuation and advertising norms. However Anagol et al (2013) further conducted a detailed study on the growth of mutual funds in India using Mutual Fund Registrar CAMS data in the pre and post implementation of the entry load ban reform. Their analysis suggested that the low growth in mutual funds post the 2009 ban on entry load was for reasons independent of the policy change, such as general move to other real asset - non financial classes namely gold and real estate following the 2008 financial crisis. The flow into other asset classes is reflected using Government of India’s Public Account data available through the NCAER (2011) report.

These are two contradictory viewpoints. In either case, the intermediary or the distributor in India has witnessed a fall in the Assets under management (AUM) and thereby impacting his revenue stream. This paper presents the emerging distribution structure for mutual fund products in India with regards to the IFA.

In India the distribution model that was being followed was that of intermediary selling directly to the customer and being remunerated by the manufacturer. This advice was likely to be biased because the incentive came in from the product manufacturer purely as commission for sale and not from the customer on account of customer satisfaction. Stoughton, Wu and Fechner (2011) found that kickbacks to advisers from product providers were always associated with higher performance management fees and it negatively impacted fund performance. Inderst (2009) captures those regulations made the consumer market safer, but often led to unintended consequences of potentially stifling innovation. The regulator SEBI rolled out a series of measures beginning 2009 to address this agency problem, and these are summarized in brief below.

Summarising critical regulatory changes since 2009:

- The entry load removal norms were the foremost of the changes initiated by Sebi in 2009. It was geared towards protecting investor interest and bringing in more transparency in India’s Mutual Fund industry. This regulation impacted both the investor and the distributor segment.
- Introduction of the Know your distributor (KYD) process for Mutual Fund Distributor in August 2010 & Know your Customer (KYC) in December 2010. As a measure to control fraudulent investment distribution, this regulation mandated distributor to submit his ARN card with address proof document to the registrar. Under KYC norm, client’s address and identity proof was to be submitted and also risk based due diligence carried out while taking his investments.
- Introduction of Transaction Charges & Process for Distribution of Mutual Fund Products: Sebi Vide circular dated August 22nd 2011, allowed charging of separate transaction charge of Rs.100 for investments above INR 10,000/-. Investors could continue to pay directly to the distributor for services rendered and other factors. For distribution of Mutual Funds by distributor, a classification of the distributor (based on parameters like AUM, commission received, geographical presence) and due diligence process outlined which was to be undertaken by AMC. It also mentioned that risk profiling of investors was mandated. It further classified customer relationship and transaction charges into Advisory & Execution only.
- Steps to Re-energise the Mutual Fund Industry: The regulator on September 13th 2012 laid out steps comprising of allowing of additional Total Expense Ratio (TER) and Service Tax, Single plan structure for mutual fund schemes to initiate scheme consolidation, Direct channel option, introduction of newer cadre of distributors, investor education programmes by AMC amongst others. These measures were primarily geared to bring in transparency and simplicity in the mutual fund distribution space.
- Introduction of Direct Channel and Impact: Under the direct channel option the regulator mandated, 1st January 2013 as the launch of Direct Plans by Asset Management Companies, which will offer the intelligent and large investor a direct investment platform at a saving of 50 to 75 bps. In November’ 12, a number of large treasuries informed the distribution network of decision to invest through this platform January 2013 onwards. Discussion with industry experts ascertains that the IFA segment will see a decline in the number of investors through their code and thereby takeaway the trail commission also. Foundation of Independent Financial Advisors (FIFA) made representation to AMFI in this regard, and was awaiting the intervention.