Challenges of Indian Mutual Fund Industry

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Abstract

This paper provides an overview of mutual funds, investment vehicles that pool the savings of number of investors to invest in different type of securities. These could range from shares to debentures to money market instruments. In this paper an attempt has been made to discuss the origin of mutual fund industry, its structure and regulatory regime. This paper further discusses the challenges to mutual fund industry in India and its future prospects. The study is based on various research literatures on mutual funds. A library research method has been used for the study. Different books, journals, periodicals and online papers have been observed. Mostly secondary data has been used in this study.

Key Words:- mutual funds, money market instruments, challenges to mutual fund industry,

Introduction

India has been the fastest growing markets for mutual fund industry. With progressive liberalization of economic policies, there has been rapid growth of capital market, money market and financial services Industry including merchant banking, leasing and venture capital (Tripathy, 1996). The increasing globalization of financial groups, rapid spread of multinationals and strong excellent performance of equity and bond markets in India has led to the evolution of mutual funds. Now it has evolved from a single player monopoly in 1964 to a fast growing market. To the date assets under management of 38 mutual funds stood at Rs. 7, 47,524.58 crore. Increasing number of mutual funds in the developed financial markets indicate investor's preference for the mode of investment (Huhmann, 2005, Talat AFZA and Ali Rauf, 2006). Mutual funds deploy their funds in marketable instruments. So well developed securities market is pre-requisite for the successful operations of mutual funds.

Origin and Legal Framework of Mutual Funds in India

The concept of mutual funds evolved in India in July 1964, when at the initiative of the government of India and the Reserve Bank of India, Unit Trust of India was set up to mobilise the savings of the middle class investors and to invest those funds in the capital market for the much needed industrial growth. As only 1/3 of household savings were at the disposal of the corporate sector, UTI was established to channelize large shares of household savings to productive investment in the corporate sector. Regulatory framework of Indian mutual funds industry matches with the most developed markets of the world. Securities and Exchange Board of India has been introducing several regulatory measures on wide range of issues including the financial capability of players to ensure resilience and sustainability through increase in minimum net worth and capital adequacy, investor protection and education through disclosure norms for more information to investors (KPMG).

We can put mutual fund industry into following four phases

First Phase (1964-1987): The first phase was between 1964 and 1987 when Unit Trust of India (UTI), the only player, was set up in 1963 at the initiative of government of India and the Reserve Bank of India (RBI) under the act of parliament. Since it was set up by the Reserve Bank of India, it functioned under the regulatory and administrative control of the Reserve Bank of India. Later the Industrial Development Bank of India (IDBI) took over its control and it was delinked from the Reserve Bank of India in 1978. At the end of 1988 its total assets under management were Rs.6, 700 crores.

Second Phase (1987-1993): During second phase public sector entered the Industry. Total of eight funds were established, six by banks and one each by LIC and GIC. State bank of India was the first to set up its mutual fund followed by Canra Bank mutual fund in December 1987, Punjab National Bank mutual fund in august 1989, Indian bank mutual fund in November 1989, Bank of India mutual fund in June 1990 and Bank of Baroda mutual fund in October 1992. The total asset under management had grown to 61,028 crore at the end of 1994. Total number of schemes offered by mutual funds during this period was 167.

Third Phase (1993-2003): During this phase private and foreign sectors mutual funds entered the industry. The Kothari Pioneer was the first private mutual fund to be established. For the first time SEBI came out with comprehensive regulations in 1993 which were revised in 1996. The industry now functions under the SEBI (Mutual Fund) regulations 1996. At the end of January 2003, there were 33 mutual funds with total assets under management worth Rs. 21,805 crores.

Fourth Phase (Since February 2003): Following the repeal of UTI ACT 1963, it was bifurcated into two separate entities in February 2003. One is the specified undertaking of UTI, functioning under rules framed by government of India. Hence does not come under the purview of mutual fund regulations. The second undertaking, UTI Mutual Fund Ltd, (registered with SEBI) ; was sponsored by State Bank of India, Punjab National Bank, Bank of Baroda and Life Insurance Corporation. It functions under the mutual fund regulations and at the end of January 2003 had assets under management worth Rs. 29,835 crore.

Benefits of Mutual Fund Investment

Mutual fund investors enjoy the benefits of portfolio diversification, professional management at low cost and greater transparency compared to other financial institutions, such as banks, thrifts, insurance companies and pension funds.

Diversification: Investor can diversify his portfolio through mutual funds without requiring large amount of funds as mutual funds invest in a number of companies across different sectors and industries. It also helps him in spreading the risk over a range of securities. So the diversification reduces the risk as all the stocks do not decline at the same time and in the same proportion.

Professional Management: Investment in mutual funds also enables the investors to reap the benefits of professional management. Mutual fund team includes the experienced and skilled professionals who manage investor's money professionally. Investor does not have to bother about what to buy or sell; it is the mutual fund's manager who will handle all for you.

Economies of Scale: Mutual funds are able to take the benefits of scale in brokerage, custodial and other fees because of their buying and selling in large size. Transactions on a larger scale can be done for less money.

Convenience: Mutual fund saves investor's time and efforts involved in researching, buying and selling securities. All this can be done through telephone, e-mail or online. It also reduces the paper work and helps the investor to avoid many problems like delayed payments; bad deliveries etc. and make the investment easy and convenient by automatic reinvestment of dividends and systematic withdrawals and even tax reporting.

Liquidity: Mutual funds investments are liquid and investor can easily get in and out of the scheme with much ease. In open ended schemes investors can easily sell his units during the market hours at Net Asset Value. While in close ended schemes he can sell his units at the prevailing price on the stock exchange.

Transparency: Mutual fund investment gives greater transparency to investors by providing the investors with extensive disclosure of material details. He gets regular and complete information on the value of his investment, class of assets in which funds are invested and investment strategy of fund manager.

Challenges and Future Prospects

India being riding on high household savings with attractive investment rates will prove to be a big destination for investors. As per KPMG, the mutual fund industry in India is expected to grow at explosive rate of 20 to 25 percent from 2010 to 2015 and consequently AUM may grow from 16000 to 18000 billion. Attractive fees structure, declining brokerage fees and increasing household savings are attracting large numbers of international and domestic players to set up their mutual funds in India so that they may harness the future growth potential. In the light of ample opportunities in the industry and rapidly changing demographic profile of investors, we feel the below mentioned challenges are needed to overcome to reap the potential benefits.

1. **Limited Range of Products:** Since industry has been focusing little on product innovation and development, it failed to provide products which cater to entire life cycle needs of the investors. So the mutual fund industry needs to introduce products that cater to ever changing needs of the investor and also enhance returns to both investor and fund.

2. **Lack of Investor Awareness:** Financial literacy and investor awareness is very crucial to increase the penetration levels and channelizing household savings into mutual funds. But unfortunately it is very limited, especially among rural masses. So it is imperative on the part of fund managers to launch campaigns to educate the rural masses about mutual fund investments and their benefits.
3. **Limited Distribution via Public Sector Network:** There is limited distribution of mutual funds through public sector. Indian postal services, which is the largest in the world is selling the mutual funds of just only five asset management companies and that too in Tier 1 and Tier 2 cities. Rural participation in mutual funds is very poor. Banking infrastructure, combined with distribution services and technological solutions can play an important role in the mutual funds distribution especially to target the retail segment.

4. Competition from New Entrants: UTI had held a monopoly in the market for almost 30 years. But after the liberalization of mutual fund industry in 1992, large number of private and foreign mutual funds has entered the industry and has intensified the competition. Economic reforms have made the entry of new funds relatively easy at relative low costs. Consequently vast number of funds are operating and competing with each other on many fronts such as product innovations, fees and performance.

5. Technological Advancement: Phenomenal growth has been seen in technology in last few years. Fund managers have started introducing such innovations such as transacting through internet, ATM cards, alerts through SMS etc. It has reduced the paper work, transaction costs and has fastened the document processing along with instant access to information. But the mercy is that such innovations can cater to the needs of only urban population as rural masses are yet to be made literate as far as these innovations are concerned. This poses another challenge for mutual fund industry.

6. Fees Structure: The fees structure of mutual funds is quite inflexible. A fund manager charges fixed fees from fund customers regardless of the quality of advice given by him. Expenses have been rising continuously but fees structure is fixed.

7. Exodus of Talent: In case of mutual funds there is huge pressure on the fund manager as he has to ensure the conformity to elaborate regulations and disclosure requirements. Hence besides the superiors, his work is open for scrutiny by peers, regulators, media and common investors. While pressure is rising and the rewards are shrinking, fund managers are looking for employment opportunities elsewhere. In the past few years approximate 65 percent of talent has ventured out of the industry. So it has become a challenge for mutual funds to manage the talent.

8. Compliance with International Standards: Mutual fund industry has seen a lot of changes with the advent of multi-national corporations into the country, bringing in their professional expertise in managing funds. Thus the Offshore business and intensifying competition from global fund houses requires the compliance of International accounting and reporting standards like IFRS (International Financial reporting standards) and GIPS (Global Investment Performance Standards). So all these compliances has been posing another challenge for mutual fund industry.

As mutual fund industry in India has been flourishing at fastest rate, the challenges discussed above needs to be addressed at the earliest to ensure sustainable and profitable growth of this sector.

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