Why Indian fund houses must rethink business models

Rising costs in India's mutual funds sector means that asset management companies need to be able to manage margins and boost profitability – if they expect to see continued success, believe investment leaders in India.

Despite the boom in asset growth in recent years within India's mutual fund industry, the rising costs and moderating margins mean that future profitability for asset management companies depends on them improving efficiencies and driving product innovation.

This is made even more important given the competitive nature of the industry, with 40-plus fund houses operating in the country.

These were among the views of senior industry executives as well as top product gatekeepers at a recent roundtable organised by Hubbis in Mumbai.

Despite the five-fold growth in assets already over the past decade, to INR17.6 trillion (USD270 billion) – and the total number of folios in at the end of March at 55.4 million – some practitioners expect the investor base could double over the next three years.

Plans industry-wide to step up investor awareness campaigns will play their part in this. However, the fight for greater market share has seen many fund houses increasingly handing over higher commissions to distributors.

And as some investment leaders believe, each asset management firm has a choice about how much profit it wants to retain.

MOUNTING CONCERNS

From the common 50:50 split in fees in India in years gone by between the distributor and asset management company, the balance has shifted in favour of the wealth managers.

This is creating a new dynamic among product providers. While the larger fund houses are more likely to be able to operate on wafer-thin margins due to their sheer scale, the fee tactics put immense pressure on smaller players.

Overall, this is forcing many firms to rethink their business models in order to remain viable.

For example, investment leaders believe that the industry remains (overly) reliant on third-party distributors.

Nevertheless, it is also a fact that mutual fund agents in India generally earn far less than their counterparts selling insurance. According to a PwC report entitled 'Mutual Funds 2.0: Expanding into New Horizons', the first-year commission for insurance agents in India can be as high as 35%, and around 7.5% in the second and third years.

By contrast, mutual fund agents may earn around 0% to 0.4% as a one-time brokerage fee, and 0.5% to 0.75% as trail commission.

Further, with compliance requirements and salary expenses rising significantly

over the past few years, margins are expected to compress further and put yet more pressure on bottom lines.

FINDING THE BALANCE

Regulatory changes are also making life tougher for players in the mutual fund industry. In a consultation paper released in late 2016, for instance, capital markets regulator SEBI proposed the separation of advice from distribution.

In short, distributors of mutual funds were previously allowed to offer advice "incidental to the sales process". Under the new proposed regime, if they want to offer advice, they will have to become Registered Investment Advisers within three years; if they don't, their role will be reduced to distribution only.

However, India is a market where more than 90% of Indian households don't invest in mutual funds. What is needed, therefore, is greater operating efficiency and productivity to capitalise on the growth potential in a way which is profitable, according to industry practitioners.

Certain market trends are in their favour. For instance, high disclosure standards, a reasonably good track record, rising awareness of financial investment products and improving ease of transactions for first-time investors (via electronic KYC, for instance) continue to boost growth prospects for the mutual fund industry.

The regulator also seems to be continuing to look for ways to enhance expansion and penetration, according to the PwC paper, via tie-ups with e-wallets and e-commerce distribution channels.

Plus, there is growing awareness of the need to create financial products that cater to various needs and appetite.

WHY INDIAN FUND HOUSES MUST RETHINK BUSINESS MODELS

SEBI is already promoting the alternative investment fund (AIF) platform, for instance, which should encourage innovation around real estate and structured credit. Eventually, other types of products such as infrastructure investment trusts should come to market.

Innovation is needed, according to investment leaders, since the majority of the 2,000 or so mutual fund schemes on offer in the market today are highly commoditised.

Efforts to change this are, however, underway to some extent.

Over the past 12 months, these have included new fund offers for new genres of products – such as fixed maturity plans, retirement focused funds and hybrid funds, the PWC paper noted.

REGULATORY STABILITY

Market practitioners also believe in the view that stable regulation would go a long way in improving the overall outlook for asset management in India.

After all, how can the industry grow when many people don't know what's going to happen tomorrow? How can anyone build a long-term business model on this basis?

A stable regulatory regime with rules that play out for the next five to eight years is considered ideal for growth.

Perhaps a 'super regulator' would also help fund houses to derive more synergies across financial products.

Currently, SEBI oversees equities, bonds and mutual funds, while insurance and commodity markets are governed by different regulators.

The UK and Singapore are two notable examples of markets with such an over-arching regulatory body.

And more recently, China has been considering merging its multiple regulators into one authority, according to various media reports.

However, the Indian government doesn't seem inclined to consider the creation of such a super-regulator for now.

Yet some investment leaders believe there is a case to be made for having such a similar structure in India. ■