

Opportunities and Challenges*



The Knowledge Partner

About PricewaterhouseCoopers

PricewaterhouseCoopers Pvt. Ltd. (PwC) provides industry - focused tax and advisory services to build public trust and enhance value for its clients and their stakeholders. PwC professionals work collaboratively using connected thinking to develop fresh perspectives and practical advice.

PwC is the leading professional services provider to the world's top financial services organisations. We have an industry focused practice dedicated exclusively to the investment management, banking, capital markets, private banking/ wealth management, mutual fund, insurance and brokerage communities.

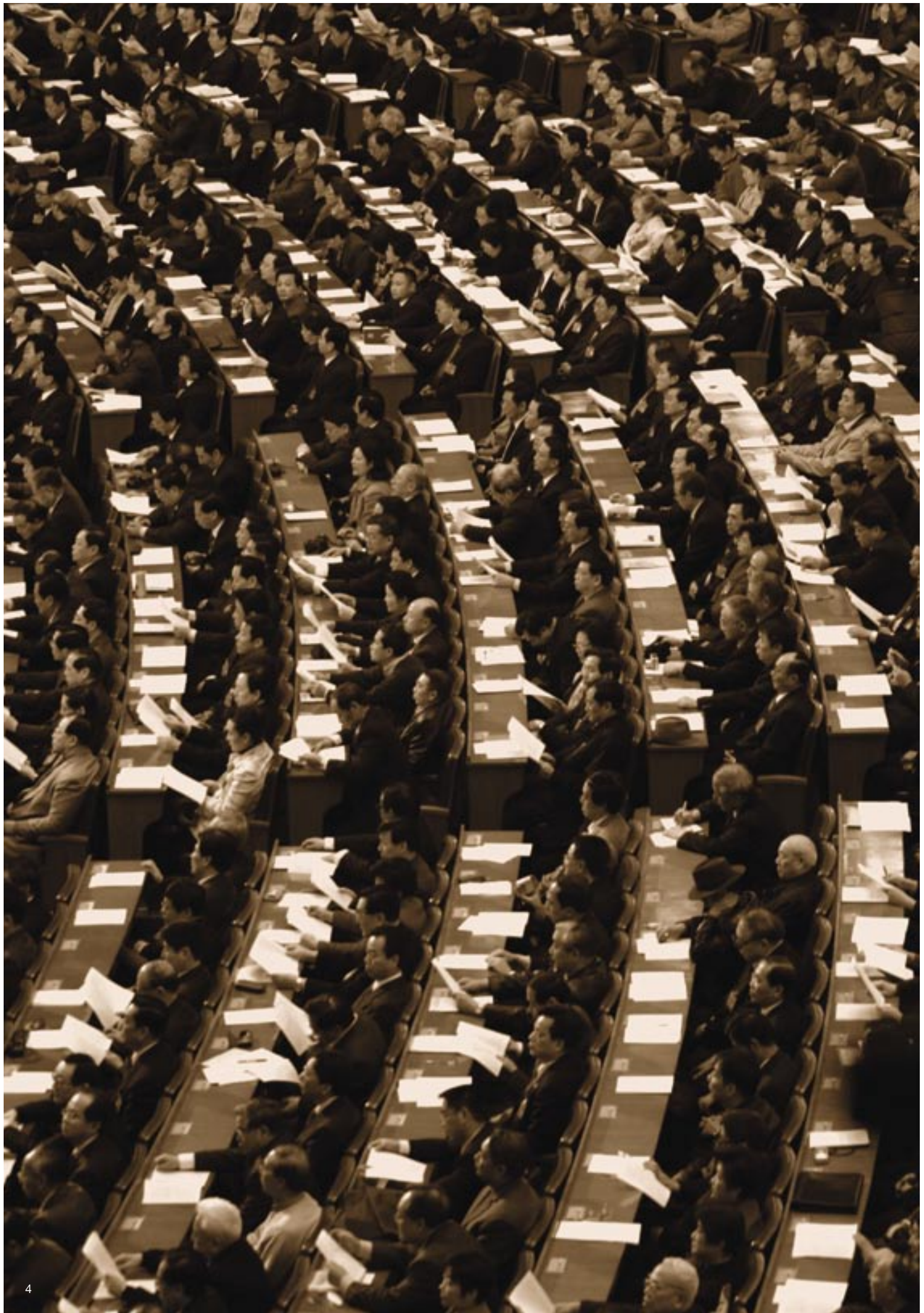
Complementing our depth of industry expertise and breadth of skills is our sound knowledge of the local business environment in India. PricewaterhouseCoopers is committed to working with our clients to deliver the solutions that help them take on the challenges of the ever-changing business environment.

PwC has offices in Bangalore, Bhubaneshwar, Chennai, Gurgaon, Hyderabad, Kolkata, Mumbai, New Delhi and Pune.



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Mumbai
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Mutual Fund Summit 2007

Indian Mutual Fund Industry: Emerging Opportunities and Challenges

The Mutual Fund Summit, under the aegis of CII is intended as a conclave of industry players, regulators and policy makers and industry associations. It aims to provide a platform for identifying industry level issues and directing policy level and structural changes.

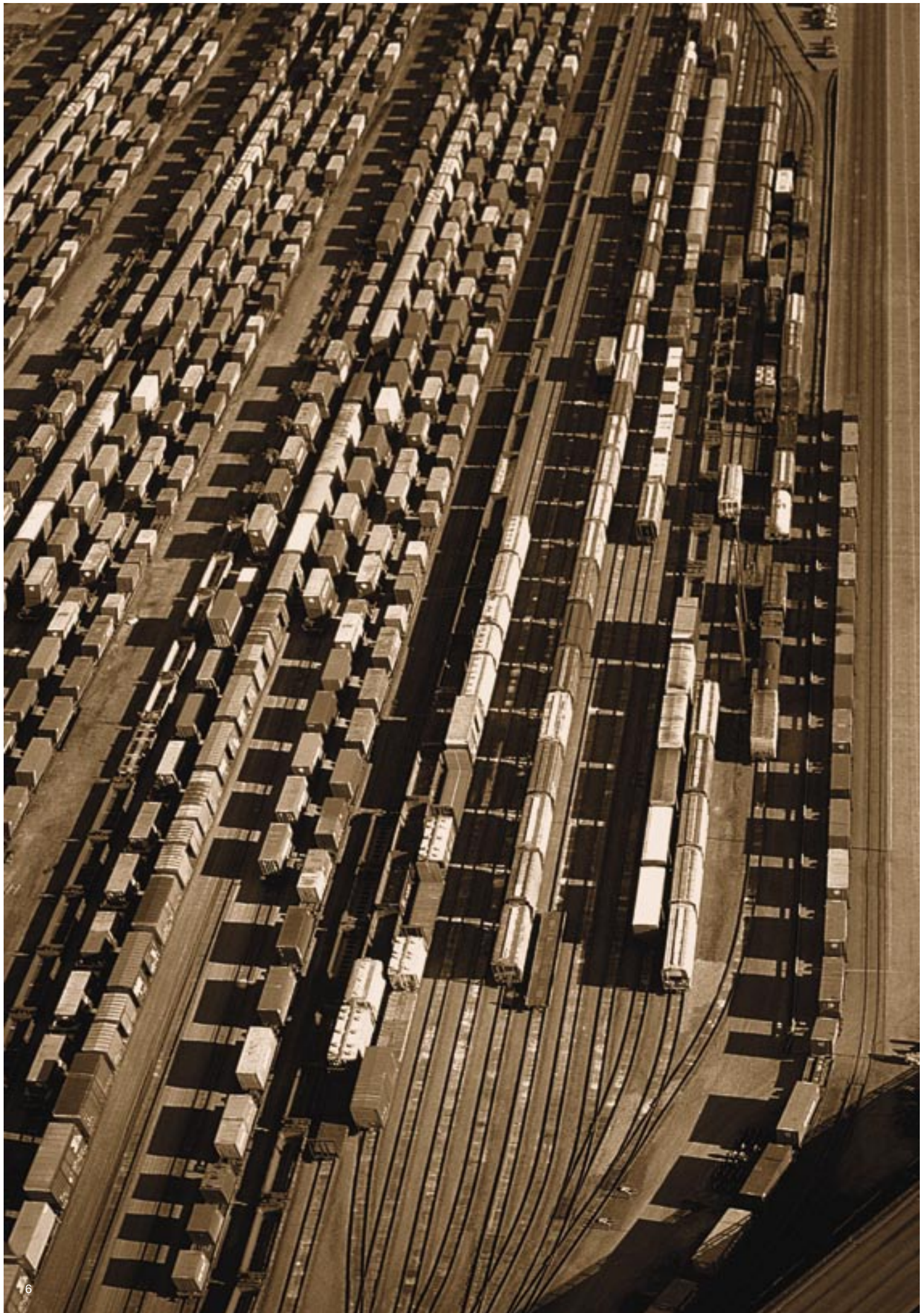
Background and Objectives

In a normal life span an individual moves through three clear stages of demand; necessity, comfort and luxury. As lifestyle changes occur and the economic environment undergoes a change, there is a gradual shift whereby comforts become necessities and what was once a luxury becomes comfort. What has this basic economic theory got to do with investing, one may wonder? Well, read on....If one were to apply the same logic to the investing life span of an individual over the past few years we had a vast majority of investors investing in fixed income products such as fixed deposits and postal saving schemes. These were the necessities of any investment portfolio. Then came the mutual funds, that too investment in guaranteed return products of the Unit Trust of India, primarily US 64 or Bank Sponsored mutual funds, which were regarded as comfort. Investing in equities and insurance, which were last on the list of investment priorities, were termed as luxury.

The economic environment in India has changed over the past few years, especially after the outsourcing boom. Continuously softening interest rates, rising inflation to go with the rising standard of living and meteoric rise in the equity markets meant that it was time to make the comforts, the necessities and a new era of investing has thus evolved. Mutual Fund investing has now become a necessity and for the more comfort-oriented investors it's investing in equity. Portfolio management and structured products now don the luxury tag. It is indeed heartening to know that more and more retail investors are participating in the growth story of their motherland through the mutual fund route. Mutual funds have provided a very significant wealth creation opportunity to investors without them having to go through the rigmarole of direct investments in equity. The ever vigilant regulator has ensured creation of a strong governance base which has further added to the investor confidence. These factors have led to a steady growth in assets under management which has registered an increase of over 40% for the second year running.

In the past year, next generation products such as capital protection oriented schemes and gold funds have been launched. The collections which have been mopped up in close-ended equity Schemes with a lock-in period have surprised many an expert. Commodity funds, real estate funds and global funds represent the next stage of emerging opportunities to the mutual fund industry. The results of the economic boom have now started showing up in semi-urban and lesser developed cities as well. These pockets also present increasing growth opportunities to the industry. Anyways with increasing competition, tapping the earlier untapped markets is now a matter of compulsion rather than choice! New players have been granted licenses, few more are in the pipeline and the competition's just getting hotter. It may well become a survival of the fittest. Growth within the existing governance structure is today one of the key challenges in the industry. As the Indian mutual fund industry matures further and aspires to go global, compliance and governance would assume key significance.

Product differentiation and quality service standards would be the key enablers which could make a difference between boom and gloom for fund houses. Opportunities are a plenty and challenges galore. The objective of this background note is to provide a snapshot of some of these opportunities and challenges and thereby serve as a contextual guide to the Summit.



The Opportunities ...

The assets under management for the mutual fund industry have crossed Rs. 3.5 trillion. And yet many say we are just getting started. It is this panache which is driving more and more global fund houses towards destination India. Experts argue that till the overall size of the market does not increase, with more and more fund houses biting into the same pie of urban investors and asking for an increased share of the same wallet, the entire mutual fund business in India may turn into a red ocean of bloody competition. Fund houses too are beginning to realise this and are re-writing the ground rules to ensure that overall market size increases. A classic example is the introduction of Systematic Investment Plans with investments as low as Rs. 50 or Rs. 100 a month.

The current macro-economic environment, despite concerns around rising inflation and expected slow down in the economic growth rate, presents a unique set of opportunities for fuelling the growth of the mutual fund industry.

High cost of business in Tier I cities

The high cost of doing business in Tier I metro cities, primarily due to high cost of real estate have forced corporate houses, especially multi nationals who have off shored their back office operations to India, to look at the economically more viable Tier II cities. This would eventually result in the creation of the income effect in these cities and towns. Higher income generally results in higher saving potential and these savings could then be channelised to mutual funds.

Interest rate scenario in India

Traditionally, mutual funds were looked upon by retail investors primarily as an option to direct equity investing. However, in the wake of a correction in equity markets and the north bound movement in interest rates, fixed maturity plans offered by mutual funds, which are akin to fixed deposits have caught fancy with the retail investors.

Development of commodity exchanges

The relatively quick development of two commodity exchanges in India, the Multi Commodity Exchange of India Limited and the National Commodity and Derivatives Exchange Limited, may prove to be a blessing for the mutual fund industry. The two exchanges are clocking record turnovers in commodities like gold and silver and provide an advanced commodity trading platform for institutions and investors. A vigilant regulator in the form of the Forward Markets Commission keeps a very close watch on the commodity market thereby building investor confidence.

Commodity funds which are quite popular in the mature markets may just be able to make a debut in India. The Summit takes a look at the state of preparedness of the industry and the regulator to introduce commodity funds in India.

The Real Estate boom

With the liberalisation of Foreign Direct Investment rules in real estate by the Reserve Bank of India, the sector has seen an influx of foreign funds which has lifted the real estate prices to dizzying heights. The traditionally closed construction sector is now in the public eye and this will lead to a more transparent real estate market.

Real estate has always been one of the preferred investment avenues for the Indian investor. And what better way for the smaller investors to participate in this boom than to have a real estate mutual fund. However, a real estate mutual fund would come with its own set of challenges. SEBI on its part would be keen to ensure that all relevant regulations are in place before real estate mutual funds kick-off as this being a sensitive area any negative event could have a severe impact on investor confidence. The Summit would provide an insight on key areas such as valuation, declaration of net asset value and accounting, on which discussions have been initiated by the working committee on real estate mutual funds.

The opportunity to Go Global

It's been a good year for India. Indians have made headlines globally from making big ticket international acquisitions to earning global awards for the most consistent fund performances. The India growth story was known to all; but now its time to make way for the global Indian. The Reserve Bank of India has also added the right ingredients to further spice it up for the mutual fund industry. Indian investors are now allowed to invest upto USD 100,000 abroad. Its time to go global! But opportunities always come with challenges. The steps have been initiated but there's a long way to go. Fund managers having proven their mettle locally would be ready to take on further challenges. But the risks are manifold. The retail investor ultimately has to be convinced about the opportunities available in the more mature global markets and the time's just right to make a beginning. With a strong regulatory framework, clear guidelines and the talent to back it up, the Indian mutual fund industry is in a position to cater to the new breed of investors who are keen to diversify their risks.





...And the Challenges

Growth versus Governance- A right mix

The Indian Mutual Fund industry has held its ground in the midst of adversities in the capital markets thanks to the strong regulatory framework in place. An increasing responsibility is being placed on the Trustees to ensure that the operations of the funds are managed to the full benefit of the unit holders. As the number of players in the market increases, competition may force fund houses to comply not only with the laid down regulations and concentrate more on growth but endeavor in creating excellence in governance as well. In this challenging environment, the debate of growth versus governance is surely set to assume greater significance.

Regulations- What more is needed?

As the industry moves on from its nascency to adolescence, it is joint responsibility of the industry players, the regulators and also the investors to ensure that it further transits to maturity as smoothly as possible. A strong regulatory platform is a key challenge in any business environment, more so in the Indian context at this point on the growth curve of the industry. While we do have a strong regulatory platform in place, more can be done based on the experience of mature markets like the US and UK, where investor protection has assumed top priority. The industry is well governed with a spate of reactive regulations and its now time to introduce more proactive, growth enhancing regulations.

Administration and Distribution

No discussion on mutual funds can be complete without touching upon the aspect of distribution. A lot has been spoken about the need to increase penetration of mutual funds in Tier II and Tier III cities. Rural participation in mutual funds continues to be poor. Such poor penetration has much to do with lack of investor awareness, inefficiencies in fund transfer mechanisms, presence of safer substitutes and cost of establishing presence in smaller areas. Fund houses cannot fight this battle single handedly. They need adequate support in terms of banking infra structure, distribution services and technological solutions to ensure a sustainable cost-benefit model of growth. Even in terms of the transfer agency function, the choice of players was very limited which too sometimes places a constraint in terms of ensuring administered growth. However, with more players entering the business, watch out this space for more action.

Investor Education- A thrust on financial planning

The efforts taken by the industry and AMFI towards investor education are definitely showing results. The media is also making a fair share of its contribution. Today, we have news channels, running dedicated shows for mutual funds, wherein fundamentals of investing in mutual funds are explained and queries of investors are answered by experts. However, the fact remains that in our country mutual funds are sold rather than bought. And this trend has been observed uniformly across all classes of investors and for all kinds of products. This is where professional help is required. The economic boom in our country has led to the emergence of a very strong Small and Medium Enterprise (SME) sector. Banks and financial institutions are also vying for a stake in wooing this niche business segment. However, the focus of SMEs has primarily been in the manufacturing sector. The services sector could also be accredited with this status. This would help professionalise financial planning in our country as is the trend in mature markets like the USA. The Certified Financial Planner accreditation can now be acquired in India. With the right kind of assistance from the banking sector, we could have an army of entrepreneurs willing to take up financial planning as a very profitable business option and this could go a long way not only in ensuring professional education and guidance to the investors but also in improving the long term financial health of investors.

The technological backbone

Fund houses have introduced interesting technological innovations such as transacting through the internet, net asset value updates on mobile phones, unit balance alerts via SMS messages, transacting through ATM cards etc. However, these innovations currently cater to the already pampered urban class of investors. The internet revolution in our country is yet to penetrate to the grass root levels. The per capita usage of internet in our country is still very low compared not only to the developed countries but also as compared to our developing peers. Mobile telephony comparatively has grown exponentially. Herein lies another important challenge for the industry. It is very important to strike the right balance while choosing to invest in technological advancements. As mentioned earlier, the industry is now at a stage where to progress to the next level of growth, it needs more support from other sectors in the economy. A few fund houses with deep pockets may be able to make necessary investments in the required technology. But for the long term benefit of all the players in the industry, it is indeed necessary to join hands with other sectors of the economy such as banking and telecommunications.

Diminishing talent pool

Print media these days has dedicated space to capture resource movements between companies, especially in the financial services sector. The acute shortage of talented resources is slowly but surely showing its impact. The pool of talented people is diminishing and staff costs are soaring. The key challenge is to find a permanent solution to tide over this acute shortage. One possible solution could be for the industry through AMFI to tie up with universities and colleges to offer programmes dedicated to the financial services industry in general and the mutual fund industry in particular, which would cover various critical aspects of the financial services industry ranging from fund management, research, analysis, treasury, operations and accounting. Aspirants acquiring accreditation in these courses could then be directly channelised into the various subsets of the financial services industry. This could ensure a continuous steady supply of talented resources to the industry.



What would these challenges lead to...?

Pressures on Margins

To effectively tide over the challenges, fund houses will have to expand their cost budgets which may put pressure on margins in the short run. Reduced margins may have the effect of funds houses flexing their muscles to garner a higher market share of assets under management to enjoy the benefits of economies of scale. This will surely benefit the investors in the long run as they would be able to enjoy better service standards and more product differentiation. Increasing regulations may also bring about an increase in the cost of compliance.

Consolidation in the Industry

Increasing challenges and growing competition may make it difficult for the smaller players to survive. With more and more new players keen on entering the market, a new wave of consolidation may spark off by way of mergers and acquisitions in the industry.

Innovation and product differentiation

Global fund houses are set to make their presence felt in India in a big way. Some of these fund houses are known globally for their specialisation in structured products and offering an array of different choices to the investors. With competition hotting up in India and most fund houses offering the same bouquet of products to the investors, product differentiation could take centre stage going forward. Innovative distribution models and service standards would also be a key distinguishing factor amongst players.

Increasing trend on outsourcing

With the industry facing a shortage of talented resources, there is an increasing trend amongst players to outsource the non-core functions and utilise the limited available resources only for core functions to be performed in house. This is a norm in mature markets for global fund houses which may set a similar trend in our industry as well. Sensing this, more players have entered the fund accounting service provider market in the last one year.

Having crossed the Rubicon and introducing the next generation products to the investors, funds house have to now roll up their sleeves and get back to the drawing board to find effective solutions to newly emerging challenges. These are interesting times for the industry. It is rightly said that Change is the only constant. The sea of changes in the financial and economic scenario in our country has brought with it a fresh wave of opportunities. These opportunities and challenges can only lead to the betterment of the investment community at large. The message to the investors is **Happy Investing!!**



About Confederation of Indian Industry (CII)

The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the growth of industry in India, partnering industry and government alike through advisory and consultative processes.

CII is a non-government, not-for-profit, industry led and industry managed organisation, playing a proactive role in India's development process. Founded over 110 years ago, it is India's premier business association, with a direct membership of over 5800 organisations from the private as well as public sectors, including SMEs and MNCs and indirect membership of over 95,000 companies from around 325 national and regional sectoral associations.

A facilitator, CII catalyses change by working closely with government on policy issues, enhancing efficiency, competitiveness and expanding business opportunities for industry through a range of specialised services and global linkages. It also provides a platform for sectoral consensus building and networking. Major emphasis is laid on projecting a positive image of business, assisting industry identify and execute corporate citizenship programmes.

With 55 offices in India, 8 overseas in Australia, Austria, China, France, Japan, Singapore, UK, USA and institutional partnerships with 240 counterpart organisations in 101 countries, CII serves as a reference point for Indian industry and the international business community.

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