New mutual fund load structure: a distributor's perspective

The SEBI's of Waiver of Load on Mutual Funds is a welcome move for investors. But one needs to analyse many factors before concluding whether this is good or bad for the entire ecosystem consisting of investor, manufacturer and distributor.

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The new No load structure proposed by SEBI for direct mutual fund investments is certainly a welcome move from the standpoint of the informed investor and the industry must appreciate the efforts taken by the regulator. Many employees and friends in the industry keep asking: is it a good move? We cannot give a straight answer. One needs to analyse many factors before concluding whether this is good or bad for the entire ecosystem consisting of investor, manufacturer and distributor. Certainly, it is far too easy to say it is good for the investor. But let us see it from others' angle too.

One should not forget the fact that even with a load structure being prevalent, the penetration of MFs and direct equities is less than 4% of the saving pie. The industry is yet to take off in the real sense. But the penetration of insurance is far better than that of MFs and direct equity. That is because of the good work done by agents and the attractive commission structure offered by manufacturers.

The point I am driving home is simple: if MF distribution is not remunerative for organized intermediaries like banks, national and regional-level distributors and IFAs (Individual Financial Advisors) they will not do it for sure.

This is very clear from the example of IPO distribution. This is a low-priority activity for the equity broker today because it is not remunerative at all and the only reason why people carry out the same is for client retention. As a result, IPO client base is not growing to the extent required. The same geographical locations like Gujarat, Mumbai, Delhi and a couple of metros take away the bulk of the market share. In turn, IPO penetration is poor across other locations. This, in such a vast country like ours, marked as it by infrastructure bottlenecks. The distributor, therefore, alone cannot work for expansion of the market expansion.

We need to raise this question: Can the MF industry on its own serve all clients (along the path of complete dis-intermediation) with control on costs, complete with a Financial Planning structure? It will be difficult to answer.

Many AMCs have far too few offices in this country and already there are infrastructure issues with R&T agents. Moving on to such a model may hamper the industry's growth, as the manufacturer alone may not be able to carry this out. Financial Planners are too few in number - though this is the best solution. One should not forget the fact that the current infrastructure for MF processing itself needs an overhaul.

Will No entry load clean up the system? Is it going to do away with many incorrect practices in the industry? Is the time ripe? The fee structure is so standardized that to serve a retail client and HNI, one gets the same fee from AMCs. This has paved way for increased rebating or pass out in the industry. So why cannot a free fee structure be implemented like in the Western countries? Let the distributor or agent decide how much a client can be charged - as in equity broking.

The industry is full of many types of practitioners. But if one needs to handle retail clients, there is certainly a cost involved - employee salary, time, travel, training, rent and technology. All this cannot be funded with only trail fee. It is needless to say that all distributors need to improve on their advice quality and service quality. But it does not mean that there are no distributors doing a good job. Else, the penetration would not have been so much. In such a scenario, people serving clients in the HNI category (and online too) may be affected the most. The impact may not be that much pronounced for distributors serving investors at the bottom of the pyramid.

The MF investor today runs to a distributor as and when he feels unhappy /unsure or there is in confusion. And this distributor network acts like a cushion for the AMCs as and when there is investor unhappiness. In fact, AMCs and perhaps regulators have not noticed this shock absorber working. In case the market falls, all MF investors together will need support and advice. Which AMC will be able to handle this? In today's market, when there is a secular bull run, such questions will be fewer. If AMCs are not available for instant remedy, investors will run to SEBI as their last resort. Are we prepared?

Insurance companies are growing in the country due to ULIP sales. This category is not very different from MFs. However, the regulations are different and many distributors have already focused on ULIP sales, which is more remunerative. Large distributors may even look at their own PMS - being the preferred vehicle. We expect many new variants of ULIPs to hit the market and compete with MFs.

An alternative solution for SEBI could involve allowing AMCs to sell MFs without entry fees but exclusively for special funds sold directly by AMC themselves (and not allowed to be sold by distributors). This can make the competition smoother. This is not the best solution though. Can the AMCs completely do away with IFAs and

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distributors? At the moment it looks tough.

I do believe it is very significant to look at what is done in the most important and mature markets. In Europe and in the US, MFs started in the 60-70s. At the beginning and over the years everybody charged full entry fees. In effect, because it was new, distributors had to invest a lot to explain and convince investors. Entry fees were critical. We can easily assume that without entry fees a lot of distributors and banks would have stopped. Why sell if I do not make money?

Top 5 Countries in the World in Terms of MF AUM

In all these countries the distributor is free to decide the entry fee. Hence rebating is legalised. And see how we are performing as a country vis-a-vis the others!

Top Countries in MF AUM's

No	Country	AUM ($ Bn)	Month
1	US	9400	Jun 06
2	Luxembourg	2620	Mar 07
3	France	2128	Mar 07
4	Germany	1417	Mar 07
5	UK	1136	Mar 07
6	India	113	Jul 07

Source: European Funds and Asset Managers Association.

Later, mainly in the last 10 years, thanks to the Internet, discounters came with lower entry fees. The Net offered a huge opportunity to offer discounts because of a technical breakthrough pushing down the cost of distribution. If we take the example of France, which has the highest MF AUM / GDP (excluding Luxemburg), the discounted entry fees arose only few years ago via Internet players. Still, the biggest share of MFs is on account of the banks - without discounts on entry fees for retail clients.

If we look at India, there is still a huge job to be done in order to reach each potential client, each potential village and each potential investor. If distributors are not well paid, they will not go everywhere and only educated and wealthy people will have access to MFs. It is really unfair for the middle and lower classes. After all, MFs allow all classes to have access to equities, bonds etc., without needing a deep financial knowledge.

MFs are made for masses. If remuneration is not adequate, they will remain an elitist product.

Some articles in the press mentioned that in some countries entry fees are up to 6-7%. It is probably true. But it is not so in the mature markets. In Europe, the maximum entry fees are 4-5% for equity funds with an average of 3%, 2% for bonds funds and 0% for money market funds. And Europe is a mature market! It means that Indian entry fees are already very low compared to mature markets, which economically is not logical. Prices are supposed to decrease when the market is mature, not before.

In addition, MF is a product where advice and quality is extremely important. It is far better to buy a good fund with high entry fees than a bad one with low or no entry fees. We are not in the mobile phone market: everybody needs or can use a mobile phone. Pushing down the price will allow more people to use a mobile phone. In the MF business, the elasticity is very low. Nobody will start buying MFs because the entry fees are lower. The main issue in the mutual funds is not entry fees but the market risk. And to explain it, you need a sales force.

Allowing AMCs to offer discounts has 3 very negative side effects:

1. It will push rebating. The client will blackmail the distributor in order to get rebate, thanks to the AMC 0% entry fees.
2. The AMC will compete with its own distributors. It is especially unfair and unhealthy. If some AMCs attempt to do so, then distributors may boycott them.
3. AMCs are asset managers, not distributors. They do not have the capacity to be everywhere in India. Management fees do not allow AMCs to open so many branches. They will do it in big cities and in the wealthy pockets. Once again small towns, rural areas and the lower classes will have no access to 0% entry fees offered by asset managers.

Here is the last point. In life insurance, entry fees are 100% opaque and the client doesn't even know about it! On average the client pays 20-25% of the first year instalment, which is huge! Nobody cares because they are well hidden. If SEBI implements its new policy, it will be a free gift for insurance companies because distributors will brake strongly on MFs and accelerate on life insurance. The gap (on the remuneration front) between MFs and life insurance is already big and many distributors are refocusing on the latter.

Conclusion

In my view, it looks like we are "missing the woods for trees". If implemented, it can potentially have some adverse impact on the growth of the MF industry. It will be desirable to have No Entry load if one invests directly with MFs; it will also be desirable if there is freedom for the distributor in pricing the fee too. I strongly believe that no entry fee for MFs bought directly through the AMC is a way to once again create a gap between educated people living in large cities and the rest of India. This, when MFs are supposed to be a democratic tool.

If bought directly from AMCs, many distributors will increase the rebating. Because of higher rebating distributors will focus mainly on places with high potential: large cities and wealthy areas. In addition many distributors will refocus on life insurance instead of MFs in order to get better margins. Once again, it will be very bad for the MF industry and its development.

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