# Some thoughts on mutual funds

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What we have seen in the last few years in the mutual fund industry is remarkable. The post COVID years, awash with liquidity and lower interest rates, facilitated by digitization, have seen a phenomenal growth in the number of investors in mutual funds, as also in the assets under management. The linear rise in the stock markets have encouraged new investors and the SIP has become most popular.

Total assets under management by mutual funds in June 24 at over Rs 61 lakh crore represented a 38 per cent growth over June 24 and double the amount in November 20. 63 per cent of the investments were from individuals (more than 99 per cent of the number of investors). Of the 18.99 crore ( 14.82 crore in June 23) individual investor accounts ( folios) in mutual funds, 10.26 crores ( 8.29 crore in June 23) were from T-30 centres and 8.73 crore ( 6.53 crore in June 2023) from B-30.

SEBI and AMFI have taken a number of measures in the last few years -especially since the ILFS and March 2020 events- to ensure that there is greater transparency to the investor, that funds are not taking risk beyond the mandate of the investor, that there is a greater degree of risk management by the AMCs, that their interests are aligned with those of the unit holder and conflicts of interest are avoided. Also measures to deal with market-wide disruption and stress have also been initiated. This follows the measures taken prior to 2018 when the focus was on changing the incentive structure that favoured an upfront commission- led distributor driven system (based on churning and turnover) to one that is focused on investor's interest.

The measures taken in the last 3 to 4 years include

- Greater transparency on risk and return vis a vis benchmarks; development of risk-o-meter and the potential risk class matrix for debt instruments based on credit risk and duration
- Simplifying product labelling and ensuring true to label
- Cost reduction through caps on expense ratio, direct plans, digital platforms.
- Risk management –liquidity norms for open ended debt funds, stress testing, valuation norms, inter-scheme transfers, segregated portfolio, exposure norms for unlisted, credit enhanced debt etc., skin in the game, enhanced disclosure on small and mid-cap funds etc
- Measures to ensure that small investors shall not be at a disadvantage as against bigger investors such as swing pricing in open ended debt funds and redemption gates,
- Market microstructure – Limited purpose clearing corporation for repos in bonds, backstop facility for mutual funds, minimum mandate on RFQ platform
- Governance issues- strengthening trustees, minimizing overlap between trustee's role and AMC's role, skin in the game requirements, mandatory voting (stewardship code) by MFs especially on RPTs.

Mutual funds are pass-through structures, where uninformed investors, who do not have the expertise and the time to enter the market directly, give a mandate to the fund manager to invest according to risk preference, and then is prepared to take the gains and losses as long as the mandate has been complied with. Also, the investors expect redemption when they choose to exit the fund. In times of sudden shocks, however, there have been many anxious moments for mutual fund investors. We saw this is 2008, in 2013, and again in 2020. An all -around drop in market liquidity for bonds, creates redemption pressure on MFs, NAVs drop, triggering further redemption pressure. So much so, that even highly rated assets do not seem to have an exit route for their assets, during such periods. Usually the RBI pumps in liquidity through the banking system at such times to create confidence and prevent a spiraling downturn. While it is true that in case of mutual funds, investors have to be prepared to take losses and gains, given the financial stability concerns, regulators intervene and, in a sense, write a 'costless put option'.

Certain issues need addressing in this context.

**Should there be a road map for gradual exit of institutional investors from the mutual funds?**

A study of the composition of gross financial savings of households in RBI bulletin of July 2024 shows that the share of equity and investment funds in total financial wealth increased by more than 50 per cent between 2011-12 and 2022- 23 from 11.2 per cent in March 2012 to 17.6 per cent in March 2023. As per AMFI data , institutional investors accounted for 37 per cent of amount of total investments in mutual funds and share of individual investors was 68 per cent. When one sees that the mutual fund penetration is a very small part of household savings, there is clear need for the industry to focus on retail investors. The AMFI investor awareness program has had good results and there is a need to drive incentives for mobilization of retail investors. As alluded to above, there has been increasing individual interest in mutual funds from beyond the top 30 centres. This is in the right direction of garnering more funds from households, rather than from institutions and corporates; the latter being informed investors should be required to directly invest in the market. The presence of institutional investors in mutual funds has implications for investor protection and financial stability and hence given both the objectives, this is an issue to be addressed in a non -disruptive manner.

The common argument is that Institutional investors provide liquidity to markets and help *all* investors including small investors, but they are also the more 'informed' investors who pull out first when there is a market sell off, leaving the retails investors behind holding the can.

Moreover, when there is a disruption in markets leading to systemic instability, the measures taken by the regulators for safeguarding financial stability makes life very 'cushy' for institutional investors.

Second, and this issue is connected whether there should be a road map for exit of institutional investors in mutual funds, relates to what happens at time of crisis and what have been the initiatives taken. The 2020 events led to SEBI and the GOI looking to creating a backstop facility in the market and the FM announced this in the Budget speech for 21-22 - 'To instil confidence amongst the participants in the Corporate Bond Market during times of stress and to generally enhance secondary market liquidity, it is proposed to create a permanent institutional framework. The proposed body would purchase investment grade debt securities both in stressed and normal times and help in the development of the Bond market.' With the backing of the Government guarantee, it can avail credit facility from banks and indirectly get access to central bank liquidity at times of market disruption. Accordingly, Corporate Debt Market Development Fund ( CDMDF) was launched in July 2023. The other market micro structure initiative is the setting up the limited purpose clearing corporation viz. AMC Repo Clearing Ltd (ARCL) for clearing repos on corporate debt securities that is promoted by all AMCs with capital contribution in proportion to the AUM of open-ended debt-oriented schemes. This is intended to boost liquidity in bond markets and thereby also provide the mutual funds the needed support. These two market microstructure measures, it is hoped, can help in stabilising the market when under stress.

**Hence the second issue is should such back stop support, albeit indirect, be available to the informed institutional investors when it the retail investors we are concerned about.**

Another issue relating to financial stability is interconnectedness between Mutual funds and the banks/NBFCs through investments in mutual funds by banks and investments by mutual funds in the bonds and commercial papers/certificates of deposit issued by NBFCs and banks. These need to be closely monitored as both the issuer and investors are regulated by financial regulators and to that extent there is a comfort to the system.

For first time retail investors, ETFs and indexed funds are ideal. The total assets in ETF funds have grown 19 times from Rs 53,533 crore in June 2017 to Rs 7,78,940 crore in June 2024; individual investors have increased their investments by 15 times in such funds. AMCs are permitted to charge up to 1% (+ GST) of daily net assets of the scheme as Base Expense Ratio for managing these funds – in practice, the actual expense ratio charged for these funds in some schemes is as low as 0.09%. At the same time, these products seem inefficient in terms of poor secondary market liquidity, large gaps between price and NAV etc. Industry needs to market these products and look at ways to address the problems cited. How can these funds be incentivised and popularised?

**The third issue relates to the structure of the mutual fund industry.**

As per SEBI Mutual Funds Regulations, a mutual fund is established in the form of a trust. It is a three- tier structure where the Sponsor forms the Trustee Company and the Asset Management Company (AMC). Trustee holds the assets of the mutual funds in fiduciary capacity on behalf of the investors and the AMC is responsible for managing the assets of the mutual fund in line with the stated investment objectives. Incidentally, collective investment as a financial activity is not regulated by a separate legislation unlike banking, insurance etc. but is subject to the regulations passed under the SEBI Act.

While framing the mutual funds regulations, consideration was given to two major factors, one that mutual funds garner large money from the public for investment in dynamic market which required specialization on part of persons performing the functions apart from reducing the cost and second that potential conflict of interest could be avoided by ensuring arm's length relationship between various functions. Therefore, the Regulations stipulated 3-Tier structure of entities for carrying different functions of mutual funds but placing the primary responsibility on trustees.

The regulations have also segregated the various roles to be performed by the trustees, AMC and custodian. The sponsor is the Settlor of the Trust and trustee holds the Trust property on behalf of investors who are the beneficiaries of the Trust. The assets of the Trust comprise of assets of the schemes that are floated by the Asset Management Company with the approval of the Trustees. Finally, the safe custody of assets of the Trust is entrusted to one or more custodians. Arm's length relationship has been sought to be built amongst these constituents by having 2/3rd trustees as independent on Board of Trustee Company and 50 per cent independent directors on Board of the AMC.

Over the years as the industry has grown there is a need to once again have clarity on the role and responsibilities of the sponsor the trust and the AMC and the accountability that these entities have.

**Role of sponsor**

Let us first look at the role and responsibility of the sponsor. There is huge variation in the mutual fund industry depending on the nature and size of sponsor. The largest mutual funds viz. AMCs with the largest AUM are invariably sponsored by large financial conglomerates with deep pockets. There is merit in this as both in terms of financial resources and talent, sponsors are able to support the AMCs and even provide them with liquidity in stressed times. From the investors' perspective the 'holding out' by such sponsor (even without any legal liability) provides comfort. Many retail investors imagine that investing in a fund sponsored by a large bank is equivalent to investing in that bank. From the regulators' perspective, there is clearly a 'holding out' risk. To quote from a Basle paper this can be called a 'step-in risk' – that arises so as to avoid the reputational risk that a group might suffer were it not to provide support to an unconsolidated entity facing a stress situation. It is worth recalling that as early as 2004, under Governor Reddy a framework was put in place as a complementary strand to the already existing regulatory structure - supervision of individual entities by respective regulators viz. RBI, SEBI, IRDA etc. In this framework and while supervising the conglomerate, inter-company dealings are monitored and adherence to the arms- length

principle is ensured apart from the compliance of various regulations relating to such exposure . It is expected that this framework of conglomerate supervision exercise could also throw up some issues where such risks can be identified and managed. This is more of a financial stability issue to be addressed by FSC and directly related to the role of the sponsor.

Several AMCs have come of age now. Sponsors have divested a good part of their holding; the AMCs are independently listed on the exchanges; it seems apposite to debate whether the AMCs should be delinked from the sponsor and the sponsor's role and responsibility taken on by the AMC itself. It will be then widely held and managed like any standalone company- of course the issues of sharing of brand logo etc. will have to be looked at. From the system's perspective, investors- especially retail investors -will then not rely just on the credibility of the name. Also, there will be a more level playing field vis a vis smaller funds who don't have a 'big name' behind them. An enabling provision has also been provided by SEBI recently with the option of becoming self-sponsored AMC being available to AMCs of mutual funds that have achieved a certain minimum threshold of number of years of operations and profitability and who would voluntarily like to dissociate themselves from the sponsor. But no AMC has availed of this provision.

Clearly there are pros and cons and this will need to be deliberated by SEBI in consultation with other financial regulators.

**Let us now turn to the role of trustee company/trustee and the role of the AMC.**

The trustee's primary responsibility is to have oversight of the AMC to ensure that the funds are invested as per mandate and true to label. The trustee has to ensure that possible conflicts of interest are disclosed and addressed. The Pros of Trustee Structure are – 1) First line oversight of mutual funds. 2) While AMCs manage the operations of mutual funds, the trustees act as supervisors of AMCs. 3) Monitors compliance of SEBI Regulations by the mutual fund and 4) Helps ensure interest of investors are safeguarded. The Cons of Trustee Structure - 1) lack of financial and operational independence could hinder effective discharge of duties. 2) Lack of adequate communication between AMC and trustees may adversely impact interest of unitholders.

The AMC's primary responsibility is to ensure that funds are invested in accordance with the mandate of the investor and there is full transparently to the investor on both returns and risk of the portfolio and the benchmark. The compliance of all statutes and regulations and have an evolving dynamic risk management strategy are the other most important roles of the AMC.

The role and responsibilities of the sponsor the trustee and the AMC was reviewed by a SEBI committee in 2023 following which SEBI issued guidelines in July 2023 on the core responsibilities of trustees and directors of AMCs that included i) defining core responsibilities ii) other responsibilities for which third party assurance could be relied upon iii) constitution of Unit holder protection committee by the AMC, appointment of an independent director as Chairman of the trustee company and holding on at least an annual meeting between the trustees/ trustee company and the AMC directors. These measures are timely and highlight the need for highly professional and independent directors who can 'smell' sources of risks and conflicts of interest and whether the regulations are being complied in 'spirit'.

**Periodic conferences of independent directors of trustees can be organised by SEBI by to sensitise the trustees of current concerns and developments so that searching questions are asked.**

**A fourth issue relates to conflicts of interest.**

This could happen especially when the AMC is part of a large conglomerate of the sponsor which has a bank, insurance company, merchant bank and other financial sector entities in the same group. The investor should not be forced into acquiring assets that are not as per mandate or which would not be in the interest of the unit holder. This could happen in particular when mutual funds are investing in primary market -in public issues (IPOs) or privately placed debt securities. An example would be the case of group merchant banker managing the issue there could be possible pressure on the fund to make investments in that offer. There could be other such situations where the "near default' but rated security/ exposure is passed on to the Fund. Mis-selling is also an example of conflict of interest. We have also seen sometimes how mutual fund or insurance products are sold to the customer who enters a bank branch wanting to make a fixed deposit. The recent instances of front running also arises from conflicts of interest and self-seeking behaviour. Trustees need to be on the lookout for possible risk on account of conflicts of interest.

**A final issue is the objective of regulations and the manner in which the rules and regulations are interpreted and enforced.**

Apart from the fact that there should be clear accountability and the right entity /person is penalised, there should be no quibbling with the wording of the regulation when it is very clear that the investor's interest has been compromised. When wrong doers are penalised and the regulator has the authority to do so after establishing that the investor's interests were compromised, needless litigation and appeals only go to weaken the regulation and generating more and more micro-regulation. If we all act in the spirit of regulation the costs of regulation to the society will be much less.

To sum up the broad issues are

- Should there be a gradual road map for exit of institutional investors in mutual funds?
- Should there be a single entity responsible for the fiduciary role and business operations role rather than the present separated trustee and AMC structure ?
- How can it be ensured that the regulatory action is based and upheld on the spirit of the law rather than the letter?

Views are personal