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Overview of the Asset Management Industry in India

Introduction

India is expected to be the third largest economy in the world by the close of the third decade of the 21st century,[*1] next only to the U.S. and China. Compared to a relatively muted world average annual gross domestic product (GDP) growth rate of 3.5 percent since 2012,[*2] India's GDP has grown at an average pace of nearly seven percent during the same period,[*3] making it one of the fastest growing economies in the world. Concomitant with a growing economy, incomes have risen and have led to higher levels of consumption and savings. Gross national savings stood at USD 720 billion for FY2016-2017,[*4] nearly 32 percent of the gross national disposable income – a very high savings rate when compared with the developed world.

Despite this very high level of savings, banks and insurance companies, such as the government-controlled behemoth Life Insurance Corporation of India (LIC), are the preferred routes for depositing financial assets by a majority of individuals and not the 41 asset management companies that are currently operating in India. This bears testament to the fact that the asset management industry is still in relative infancy. At the end of March 2018, assets under management (AUM) of mutual funds in India stood at USD 350 billion.[*5] Although the banking sector dominates India's financial asset milieu, holding nearly 70 percent of financial assets,[*6] rising incomes provide ripe opportunities for the asset management industry to expand their pie, which is further bolstered by regulatory tailwinds, positive macroeconomic outlook and favourable demographics.

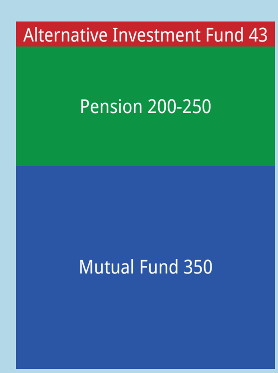
The demographic distribution of the population of India is a major asset – with a young and growing population – that was earlier seen as a Malthusian liability. India's middle class base is one of the largest in the world. The steadily increasing number of high net worth individuals (HNWIs) is also younger in average age than their western counterparts. Also 41 percent of them have their financial assets parked outside of India[*7] and a significant fraction of these assets could come back to India as the "home-bias" characteristic of developed markets takes place. This trifecta of underserved HNWIs, an expanding middle class that aspires for a better financial future, and woefully low penetration of mutual funds in India, offers immense latent opportunities for growth.

The Indian asset management industry in 2018 is about USD 550-650 billion, which is a small fraction of the global asset management industry, and is one of the worlds' fastest growing.

Ignoring pension funds, which are still some distance from being 100 percent professionally managed, mutual funds are the largest component of India's asset management industry (Figure 1).

Aside from the above mentioned professionally run companies, insurance companies manage massive asset portfolios for themselves, comprising primarily of debt and equity securities. Due to rapid technological penetration, the sector, in terms of insurance premium, is expected to grow at an annual rate of 49 percent[*8] to reach USD 280 billion by 2020. As of the end of March 2017, life insurance had the majority market share of 77 percent, and was dominated by LIC. Owing to their co-

Figure 1: India's Asset Management Industry Size in 2018 (USD Billion)



Note: Pension includes the AUM of only Employees' Provident Fund Organisation and National Pension System.
Source: Various sources compiled by authors

pious cash cycle, these companies are also one of the largest investors in Indian capital markets. As of the end of March 2017, the AUM of the life insurance industry was USD 497 billion*[9] of which 72 percent was parked in fixed income instruments.

A large proportion of investors in mutual funds are institutions – corporations, banks and foreign institutional investors (FIIs) (Figure 2). However, as technology and the internet have made it easier than ever to invest, the proportion of individual investors is expected to increase in the future.

Evolution of Asset Management in India

Mutual funds

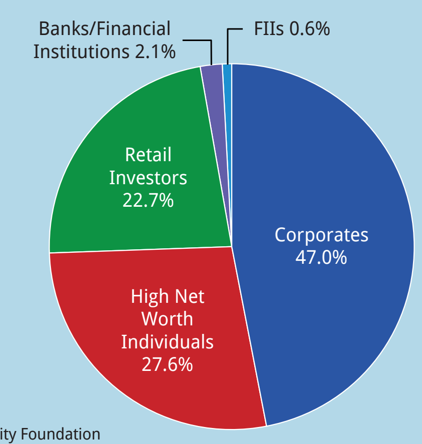
The mutual fund industry forms the lion's share of the entire asset management industry in India and has come a long way today since its humble beginnings over 50 years ago.*[10] Unit Trust of India (UTI) was established in 1963 through an act of parliament to operate under the aegis of the Reserve Bank of India (RBI). In 1964, the first mutual fund product was launched and until 1987, when a wave of public sector undertakings (PSUs) jumped onto the mutual fund bandwagon, UTI managed a paltry USD 1.22 billion. Economic liberalisation in the early 1990s saw India shedding the shibboleth of the "Hindu rate of growth" by which growth stagnated at around three to four percent per annum. With liberalisation, many private players entered into the fray and started offering varied investment products, many of which were tailor-made to a specific investor segment, based on a multitude of factors such as age, risk appetite, and sector preferences. As financial literacy increased among the masses, so did the propensity to seek out investment vehicles other than bank deposits. The last few years, from 2015 to 2018 in particular, saw tremendous inflows into mutual funds. Growth in mutual fund investment in India outpaced that in the rest of the world. *[11]

Such growth has likely come about due to the interplay of structural reforms, regulatory push and favorable macroeconomic conditions. The last quarter of 2016 saw demonetisation due to which an unprecedented amount of currency in circulation was declared null and void. As nearly USD 230 billion of defunct currency made its way into the formal banking network, bringing a sizable segment of the population under the scanners of the government, new avenues of investments that save on taxes and generate high returns, gained traction. Returns from traditional avenues such as gold and real estate, that used to witness large cash flows, waned post-demonetisation. As if on cue, mutual funds saw a veritable jump in inflows and penetration, within a year after demonetisation.*[12] The period also saw a long bull run in equity markets as mutual funds, now flush with cash, poured money into equities.

Mutual funds generally offer three distinct categories of products: closed-ended, open-ended and exchange traded funds (ETFs). While the distribution of fund schemes between closed- and open-ended categories is slightly skewed towards the closed-ended, the rupee value of the assets is heavily skewed towards open-ended. Open-ended mutual funds account for over 98 percent of all assets managed by the mutual fund industry in India.*[13] Furthermore, 88 percent of the AUM is divided among debt (38 percent), equity (36 percent) and liquid money market (13 percent) funds, and corporates, HNWIs and retail investors account for almost the entire pie of investors.*[14]

The growth in closed-ended funds has stalled following Association of Mutual Funds in India (AMFI) directing fund houses to cap upfront commissions at one percent. This, coupled with subpar performance as compared to their open-ended peers, has led to a decline in the launch of new closed-ended schemes since 2015.*[15]

Figure2: Breakdown of Mutual Funds by Investor Type



Note: As of June 2017.
Source: India Brand Equity Foundation

Pension funds

India's pension system is a complex web consisting of multiple options with varying eligibilities. Civil servants and government employees were awarded pension benefits in 1881 under the Royal Commission on Civil Establishments Act.*[16] The Government of India Acts of 1919 and 1935 made further provisions. Under these schemes, entire pension expenditure was charged in the annual revenue expenditure account of the government, thus in a way, cross-subsidising government employees over private ones. Private workers had limited options in terms of pension coverage. However, this changed with the formation of the Employee Provident Fund Organisation (EPFO) in 1952 and the launch of the Public Provident Fund (PPF) in 1968.

EPFO offers three schemes: (i) Employee Provident Fund (EPF), 1952; (ii) Employees' Deposit Linked Insurance Scheme (EDLIS), 1976; and (iii) Employees' Pension Scheme (EPS), 1995. While EPF and EPS invest in a variety of capital market instruments, EDLIS is primarily an insurance scheme. PPF is guaranteed by the government and the corpus is invested on various government schemes and programs.*[17]

The National Pension System was launched in 2004 by the Government of India in order to de-emphasise defined benefit pension plans and move to defined contribution plans. The National Pension Scheme (NPS) and EPFO employ professional fund managers.

Alternative investments

- Private equity (PE) and Venture capital (VC): The need for VC was first highlighted by the government committee on development of small and medium entrepreneurs (Bhatt Committee)*[18] in 1972. In 1973, the efforts of the Indian government to provide risk capital led to the formation of the Risk Capital Foundation.*[19] In 1986, the Technology Development Fund was formed from a tax levied on technology imports, as suggested by the budget of 1986.

The first venture capital company in India was Technology Development and Investment Corporation of India (TDICI) formed in 1986 with a view to achieve long term capital gains by investing in companies with high earnings and growth potential. Securities and Exchange Board of India (Venture Capital Funds) Regulations of 1996 freed the industry from bureaucratic hassles.*[20] Securities and Exchange Board of India (Foreign Venture Capital Investor) Regulations, 2000 enabled foreign venture capital investors to register with the Securities and Exchange Board of India (SEBI) and enjoy certain benefits. In 2012, the Alternative Investment Funds (AIFs) Regulations came into effect and proved to be a milestone for the industry. As per the act, VCs and PEs are regulated under Category I and II AIFs respectively. The act further defined the tenure of VC/PEs to be a minimum three years. It also allowed for the formation of angel funds as a special category of VC funds and defined these as funds which pool money from angel investors having net worth of at least USD 1.5 million or net tangible assets of USD 0.3 million. VC and PE investment in India were USD 32.5 billion in 2017, a year-on-year increase of 47 percent and a compounded increase of 21 percent over last five years.*[21]

- Hedge funds: In 1993, SEBI issued regulations and rules governing portfolio managers who pursuant to a contract or arrangement with clients, advise clients or undertake the management of portfolio of securities or funds of the client. Hedge funds were not allowed to operate as they did not come under the excluded category of FIIs, by virtue of their not being regulated in their place of incorporation. By FY2003-2004, some foreign hedge funds began investing in offshore derivative instruments (P-Notes) issued by FIIs against underlying Indian securities. However, the Indian hedge fund industry began only in 2012, after the introduction of the AIFs regulations by SEBI.*[22] They were regulated under the Category III that included alternative funds that engage in the use of leverage and could be either open- or closed-ended. However they were not allowed a tax-pass-through status*[23] – a serious impediment to the growth of the hedge fund industry.
- Real estate investment trusts (REITs) and infrastructure investment trusts (InvITs): SEBI introduced the first draft of regulations for REITs in 2008, but later withdrew that version to make way for real estate mutual funds.*[24] In 2013, they again released the draft regulation on REITs, but later held back due to ambiguity in the tax structure. Finally, in July 2014, the government introduced tax incentives for REITs and in August of the same year, SEBI approved the setting up of REITs in India.

REITs are set up as trusts under Indian Trust Act, 1882 and are registered under the Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations 2014. Minimum asset size to be proposed by REITs is prescribed as USD 80 million and minimum initial public offering (IPO) offer size is prescribed at USD 40 million. A REIT has to mandatorily distribute at least 90 percent of its net distributable cash flows on a half-yearly basis.*[25] Further, the REIT assets are mandated to be situated within India and cannot include hospitals, hotels, and other infrastructure such as special economic zones.

Products Offered by Asset Managers

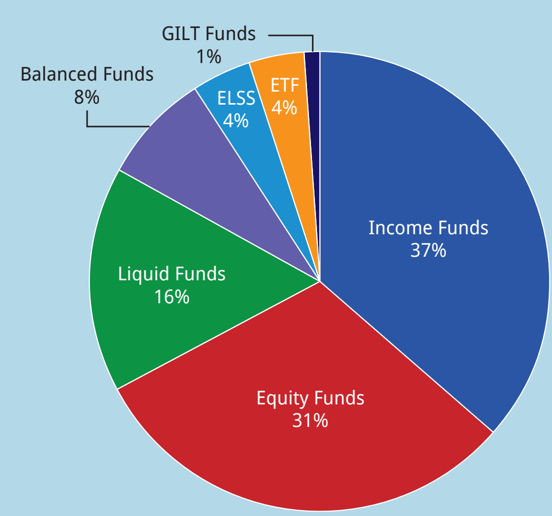
Mutual funds

In March 2018, 41 distinct providers of mutual funds offer a total of 1,998 schemes to investors.*[26] In addition to debt, equity and hybrid schemes, they also offer tax saving schemes such as Equity Linked Saving Schemes (ELSS). In terms of kinds of funds, the majority are income funds and equity funds, followed by money market funds (Figure 3).

ETFs

The analysis of publicly traded instruments would remain incomplete if it did not touch upon ETFs. These are essentially "marketable securities that track an index, a commodity, a bond or a basket of assets

Figure 3: Breakdown of Indian Mutual Funds by Type



Note: As of March 2018.
Source: AMFI

like an index fund." The major differences between a mutual fund and an ETF are that ETFs are publicly traded on stock exchanges just like stocks and bonds whereas mutual funds are not, and ETFs look to track or emulate an index/benchmark whereas mutual funds strive to beat a benchmark. The singular advantage of ETFs is transparency – the investor at all times knows the exact composition of her portfolio.

ETFs were first introduced in the U.S. in the year 1993 in the form of S&P SPDR, but they did not garner much attention from investors. But once they did, volumes swelled and today ETFs have over USD 5 trillion worth of AUM globally.*[27] In India, ETFs had a late entry in FY2001-2002 with the Nifty BeES. Growth during the initial decade was tepid and in 2011 BeES was sold to Goldman Sachs, which in turn sold their mutual fund business to Reliance Nippon Life in 2016.*[28] Now, many Indian asset management firms including ICICI Prudential Asset Management, Kotak Mahindra Asset Management and HDFC Asset Management, have launched ETFs. The muted growth of the Indian ETF industry in the early years could be attributed to the superior performance of actively managed funds, the tax-advantaged treatment of mutual funds in India, commission and fee squeeze in passively managed instruments dis-incentivising further offerings by fund houses in the category, and the behavioral bias of Indian investors toward buying investments from distributors rather than directly investing in products from stock exchanges.

But the gradual movement towards passively managed products globally has had spillover effects in India too. As of the end of March 2018, the ETF market size in India is nearly USD 12 billion, clocking an average growth of 43 percent since 2012.*[29] While the initial leanings of investors were towards the gold ETFs, equity ETFs are now experiencing phenomenal growth. This can be ascribed to the EPFO's investment in equity ETFs since 2015 and the government's plan to offload its PSU holdings through this route.

Pension funds

Among the available schemes under EPFO, EPF is the largest. Presently EPF is mandated to invest a minimum 45 percent to a maximum 50 percent of accumulated funds in government securities, 35-45 percent in debt securities, under five percent in money market instruments, 5-15 percent in equity instruments and ETFs and five percent or less in asset backed securities (ABS).*[30] EDLIS, being an insurance scheme, maintains a deposit linked insurance fund account and all expenditure and subsequent claims are credited and debited to this account.*[31] As of March 2018, EPFO had 50 million subscribers and an AUM of USD 168 billion.

As of March 2018, there were 11.5 million subscribers under NPS and it had an AUM of USD 35 billion.*[32] In a country of 1.3 billion, this is a miniscule percentage and hence a lot of growth is expected in the future. The investments in NPS are regulated under the Pension Fund Regulatory and Development Authority (PFRDA) guidelines. As of 2017, these guidelines allowed NPS corpus to be invested in government securities, listed debt and equity securities, mutual funds and alternative asset classes including AIFs (Category I and II only), REITs, ABS, and InvITs.*[33]

AIFs

As per Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, the minimum investment allowed in AIFs (other than angel funds) is USD 152,000. Further, as per the latest guideline, the minimum investment for fund-based activities by a foreign investor is USD 20 million.*[34] Also, an AIF is required to have a minimum corpus of USD three million. For angel funds the minimum corpus is USD 1.5 million.

- PE and VC funds: VC funds typically invest in early stage unlisted companies, mainly in the form of equity, while PE funds typically reduce the risk profile by investing slightly later, and prefer a leveraged investment. While PEs tend to invest in a wider range of sectors than VCs, lately an emphasis on certain sectors that have the potential to scale has been visible in PE investments as well. Over the years, Indian VCs have invested in variety of sizes,*[35] starting from a few thousand dollars to many millions of dollars. PE investments are typically much larger and in more mature companies. Both VCs and PEs are finite life, closed-end funds.
- Hedge funds: Globally, hedge funds typically use myriad active investment approaches. In India, however, most funds invest in equities – either in a concentra ted long bias (unlike mutual funds which by regulation need to be diversified) or with the ability to go long and short (unlike the mutual funds which cannot go short) typically using equity futures.
- REITs and InvITs: REITs and InvITs are new instruments in India. They essentially function as mutual funds, except that SEBI requires them to be listed through an IPO. The minimum investment by a strategic investor is set at five percent of the offering while the maximum is 25 percent.*[36] REITs are generally securitised under a waterfall structure in which securities of successively higher risk are created, each guaranteed by the cashflow leftover from distribution to the preceding lower risk security. This way investors of different risk appetite can be tapped. In case of REITs, these security classes are created not just synthetically, but also by having underlying assets of different risks; for example, residential REITs are generally considered riskier than commercial REITs due to their distributed nature as well as financial status of the tenants.

Asset Managers

Mutual funds

Of the 41 companies offering mutual funds in March 2018, the top five accounted for nearly 57 percent of the industry's AUM and the top ten companies accounted for 81 percent (Figure 4).

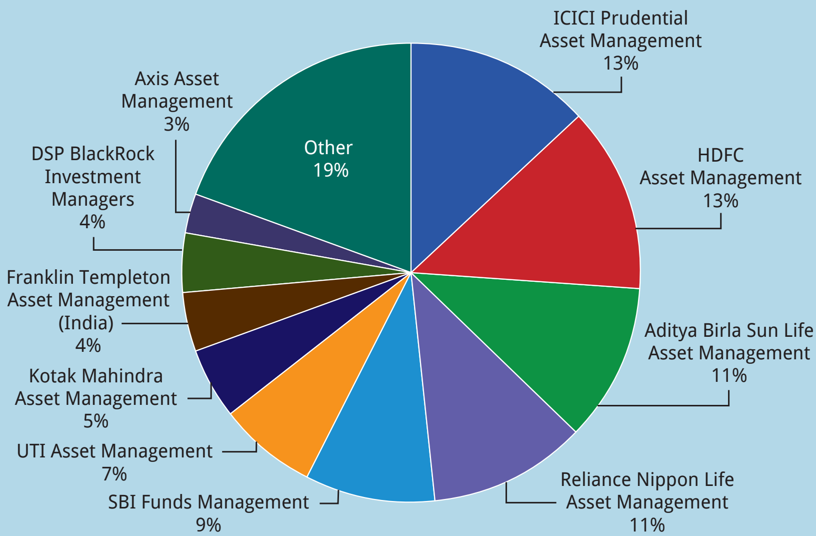
Pension funds

NPS employs professional fund managers. Eight fund managers presently manage NPS including SBI Funds Management, LIC Mutual Fund Asset Management, UTI Asset Management, HDFC Asset Management, ICICI Prudential Asset Management, Kotak Mahindra Asset Management and Reliance Nippon Life Asset Management. EPFO employs SBI Funds Management, ICICI Prudential Asset Management, Reliance Nippon Life Asset Management, HSBC Asset Management (India) and UTI Asset Management as fund managers, as of March 2018.*[37]

Alternative investment funds

There are about 395 registered AIFs in India.*[38] PEs invested USD 11.2 billion in FY2016-2017 of which a large part went to the internet and mobile payment sector.

Figure 4: Market Share of Top 10 Mutual Fund Managers



Note: As of March 2018.
Source: AMFI

Sequoia (32 transactions), Accel Partners (30 transactions) and IDG Ventures (25 transactions) were the most active VC firms in India in FY2017-2018, followed by Blume Ventures (21 transactions) and Kalaari Capital (12 transactions).*[39] Bain Capital, Caisse de dépôt et placement du Québec (CDPQ) and Canadian Pension Plan Investment Board (CPPIB) are some of the largest PE investors in India. Kedaara Capital (USD 750 million), Chrys Capital (USD 600 million), Morgan Stanley (USD 500 million) and SAIF Partners (USD 350 million) recently raised large funds dedicated to India.*[40] Most of these funds raised capital from offshore investors primarily from the U.S. and Canada. Fairfax Financial started an entire company listed in Canada, Fairfax India Holdings, with a large and growing corpus (USD 2.1 billion). Brookfield Asset Management and Fairfax are two pioneers in using foreign listed companies (permanent capital) to invest in both public and private markets in India. Purely domestic sourced PE funds were very small, with TVS Capital Funds being one of the leaders (USD 200 million). The majority of PE and VC investments in FY2016-2017 took place in the technology (46 percent), financial services (22 percent) and healthcare sectors (six percent).*[41]

As of 2018, the total size of India's hedge fund industry is about USD 3 billion.*[42] Avendus Capital is the largest hedge fund with USD 1.3 billion. There are more than 13 hedge funds in India.*[43]

India has two listed InvITs, India Grid Trust and IRB InvIT, while IndInfravit Trust (sponsored by Larsen&Toubro) is a private InvIT. The two public InvITs have underperformed post-listing and hence other InvITs have held off listing plans. As of April 2018, India Grid Trust was trading at a discount to its listing price while only recently IRB InvIT outperformed its listing price.*[44]

No REITs have been issued in India. Asset managers with large real estate interests, including Blackstone and Raheja, are planning to launch commercial and residential REITs.

The Road Ahead

In all markets, but particularly in an emerging market like India, transparency and trust are key drivers in the population's adoption of investment products. The asset management industry has innovated with products like ETFs that are transparent, low cost and tax efficient and we expect investors to gravitate to investment products with these attractive features. Hand in hand with industry innovation, we expect regulatory innovation and legal clarity to accelerate the growth and adoption of asset management products in India.

To promote growth and protect the interest of investors, SEBI has introduced several new regulations, such as banning entry load fees, separating advisor commissions from the investment amount, and removing the provision to transfer some expenses to investors. Investors are allowed to change their agent without a No-Objection Certificate (NOC) from their previous agent, and negotiate the upfront commission paid to the agent. These measures, it is hoped, will in due course give investors greater security and encourage them to invest in mutual funds. Furthermore, the government is working towards creating a robust framework to provide legal protection to foreign investors.*[45]

PEs and VCs provide capital to new, unproven business models which have strong growth potential, such as e-commerce, and other online businesses. Since these business models are new, many a times there is regulatory uncertainty around their tax treatment, which acts as a deterrent to the investors. Regulatory clarity is thus essential to invigorate investments. PE investors further seek certain provisions such as pass-through of losses at the end of the fund life (for Category I and Category II) in order to encourage investment.*[46] Hedge funds are currently not mentioned in the IT act and thus investors expect the government to bring them under a formal tax regime. Regulatory clarity is also needed in order to plug the loopholes in AIF regulation to avoid regulatory arbitrage. One such instance was highlighted by the RBI in its March 2018 letter to SEBI, asking the latter to provide clarity on loan issuance by an AIF, highlighting a case where a non-banking finance company slipped between regulatory loopholes.*[47]

Regulatory constraints and penalties on mis-selling are also very important in maintaining the integrity of the asset management ecosphere. Recent IRDAI guidelines on regulations governing web aggregators in order to curb aggressive selling*[48] and the setting up of a task-force by the government to finalise the framework of a national e-commerce policy are steps in the right direction.*[49]

There is pressure to increase investor returns from pension schemes by improving governance, enhancing equity and alternatives exposure, and involving the private sector. The EPF Scheme 1952 was amended in 2017 to allow a maximum of two terms to the board members of EPFO.*[50] These steps have met with mixed response. EPFO recently reduced its interest rate to a five-year low in 2018 despite a surplus of USD 100 million.*[51] In order to increase pension penetration among private sector employees, the government has reduced the ceiling on the number of employees in a firm and mandated more firms to provide pension coverage. The Indian labor ministry is planning to move to a public-private-partnership model to oversee its flagship provident fund and medical insurance schemes.*[52]

In spite of a government push, REITs and InvITs have not seen much enthusiasm. This is partially due to confusion on some critical regulatory matters. However, the government is taking positive steps and relaxing issuance norms such as allowing REITs and InvITs to raise funds through debt and permitting single-asset REITs, *[53] and also allowing strategic players to invest up to 25 percent in REITs and InvITs.

Rapid digitisation and governmental push in this area will see further easing of transaction processes. The Chinese example of extraordinary growth in FinTech business such as Ant Financial and Tencent, demonstrates the potential of technology in redefining the entire financial chain. As new technologies, such as blockchain and machine learning, come into usage, efficiency and access will improve exponentially. Services like robo-advisors and data-driven customised financial planning are likely to become more prevalent. SEBI and AMFI have launched several initiatives to keep India's financial services industry at the forefront of technology adoption.*[54] All this will lead to increased penetration by India's population into asset management products.

The asset management industry in India is poised to go through much change in the coming years. India is one of the fastest growing economies today and rising levels of wealth and income will see people looking for newer avenues of investment, away from traditional fixed-tenure bank deposits. Asset management companies will come up with innovative product bundles that cater to the varied needs of customers and the demand for higher returns. With the alignment of multiple factors in its favour and numerous opportunities for growth ahead, India's asset management industry is poised for exceptional growth.

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