Sebi looking to lower expense charges for mutual funds

Cut in expense ratio will help curb frequent launches of new fund offers, which distributors use to earn more commissions

The capital market regulator may reduce the total expense ratio (TER), or the sum of all fees charged by an asset management company (AMC) for managing investor monies, in an attempt to curb any misselling in the industry, said two people familiar with the regulator's thinking.

Three other people from the industry confirmed that the matter was under discussion.

The Securities and Exchange Board of India (Sebi) will take the matter up at its next board meet in February, said one of the two people quoted above.

Both requested anonymity as discussions are confidential and final decisions are yet to be taken.

A cut in TER, if implemented, will help curb malpractices such as frequent launches of new fund offers (NFOs), which distributors sometimes use to earn more commissions by encouraging investors to churn their portfolios. It will, however, also restrict ways for AMCs to incentivise their distributors.

"The regulator has come to observe that the expense ratio being charged by the Indian mutual fund schemes is higher than the global peers. The regulator is mulling steps to gradually reduce the TER," said the first person quoted above who is familiar with Sebi's thinking on the matter.

An email sent to Sebi on Thursday remained unanswered.

In 2009, Sebi had imposed a ban on so-called entry load, which was charged by AMCs at the time of investment to meet distribution and marketing expenses. This time around, Sebi is targeting TER.

Under the existing norms, the maximum expense that an equity scheme can charge to an investor is 2.5% (2.25% for debt funds). The rate is applicable in slabs and an AMC is allowed to charge 2.5% for the first Rs.100 crore in weekly average net assets of a scheme. For the next Rs.300 crore, a total expense ratio of 2.25% can be charged, while AMCs can only charge a TER of 1.75% for anything beyond that.

In 2012, Sebi had announced some incentives to re-energize the industry, which had seen growth stagnate.

Many felt this was because of the ban on entry loads, which pushed distributors towards sales of other financial products which could earn them better commissions.

In August 2012, Sebi allowed fungibility of TER, which means AMCs could be flexible on what they used the expenses for as long as they stayed within the overall caps prescribed.

AMCs, who were required to credit the money received as the exit load to the scheme's net asset value (NAV), were allowed to charge an additional 20 basis points (of the total assets under management of the scheme) as total expenses to the scheme in lieu of exit loads being credited to the scheme's NAV.

One basis point is one-hundredth of a percentage point.

To incentivise the penetration of mutual fund products beyond the top 15 cities, AMCs were allowed to charge an additional TER of up to 30 basis points, depending upon the extent of new inflows from these cities.

Sebi now feels that it is time to withdraw some of these incentives and bring down charges. According to a June 2015 report by mutual fund tracker Morningstar, expense ratios in India are among the highest.

"Most countries fall between 1% and 1.70% for asset-weighted expenses for allocation funds, with India and Canada the most expensive at over 2%. Unfortunately, Indian funds still have average to expensive expense ratios overall for equity and allocation funds. We find it surprising that equity and allocation funds have asset-weighted expense ratios above 2%," said the Morningstar report.

If Sebi reduces the expense ratios, new AMCs may find it difficult to grow while existing AMCs will have to manage costs more efficiently, said the sales head of an AMC.

"The move will mean a straight revenue loss for AMCs though such a withdrawal of provisions for charging additional expenses will act directly to check misselling. This also means AMCs will have to manage costs more efficiently and play on sales volumes rather than launching too many NFOs," he said, while adding that the timing to bring down expense ratios is right. He declined to be identified since Sebi is yet to publicly announce its plans.

Such a reduction will ensure that AMCs launch only those mutual fund schemes which can stay and grow in size in the long term, said the head of one of the country's largest AMCs.

"Many mutual fund schemes just stop growing in size merely after a few months of their launch. Such schemes earn commission for the distributors and keep generating revenues for the AMC, but they either become irrelevant to the investor or become untenable for the market condition after a few months of their launch. So, it is imperative for Sebi to find out ways to address these issues," said this person, also requesting anonymity.

In September 2015, a government-appointed committee under former finance secretary Sumit Bose called for a ban on upfront commissions and non-fungibility of cost caps within the overall TER. The government had appointed the committee to review the incentives and capping of charges imposed by different regulators across financial products in 2014.

"No doubt, the total expense ratio in India is on the higher side. I am of the opinion that the TER should be aligned with the benefits that are passed on to the investors. The regulator, instead of taking the drastic steps of immediately withdrawing the additional expenses that are currently allowed to the AMCs, should gradually phase it out," said Manoj Nagpal, chief executive officer, Outlook Asia Capital, a consulting and wealth management firm.

Sebi, however, seems to believe that some of these incentives are benefiting funds more than investors.

"As on October 2015, the 20 basis points allowed to be charged in lieu of the exit load led to a gain of around Rs.700 crore for the AMCs, whereas only Rs.70 crore was credited back to the scheme," said the second person quoted above, who is familiar with Sebi's thinking.

A recent move by Sebi suggests that the regulator has already started the process of withdrawing some of these additional expenses charged by AMCs in some categories of schemes.

In December, Sebi barred fresh equity-linked savings schemes (ELSS) from charging the additional 20 basis points in lieu of exit load credits to the scheme's NAV.

(HT Mint)