Indian Financial Distribution Industry at the cusp: Vision 2020

March 31,2015

A FIAI-CRISIL report on Indian Financial Distribution Industry

Preface

At 21%, India's household savings rate is one of the highest in the world. However, unlike in many developed nations, a significant portion of this money is channelled into non-financial assets -- primarily real estate and gold.

Since liberalisation in the early 1990s, India's financial market has grown by leaps and bounds but the wealth management industry has been confined to a very small set of mostly affluent investors. Not a conducive situation to wealth creation in a country where over half the population is below the age of 30.

At the heart of this issue is the financial distribution business, whose penetration and development has been inhibited by lack of financial awareness, operational inefficiencies and lack of incentives for investors and distributors.

This report details the financial distribution industry and the outlook for it based on secondary research and primary interactions with a large number of stakeholders. It draws up a picture of the industry taking into account its size, structure, penetration levels, geographical reach and trend analysis. It also considers various macroeconomic factors, technology trends, investor preferences and regulatory developments to identify the growth drivers/ opportunities and challenges/ obstacles.

We are convinced policymakers, stakeholders and industry watchers alike will find this a handy document for keeps.

Executive summary

The financial distribution industry in India is expected to see tremendous growth in the coming decade as a galloping economy boosts employment and raises incomes, and the much-vaunted demographic dividend drives investments into the capital markets. India is expected to log high GDP growth, which will push up household incomes and savings significantly. This will catalyse household investments of a 'young' nation where the number of households having annual income in excess of Rs 5 lakh is estimated to rise from around 6.24 crore in 2014 to around 12.14 crore by 2020.

We believe the next six years can very well spell boom time for financial products, specifically mutual funds and insurance plans, given that the economy is shifting to a higher-growth path. And as average household income rises, money managers and financial planners will have their task cut out: to steer the teeming millions towards financial investments and better potential returns for their hard-earned monies.

India's financial distribution industry has a large footprint, accounting for around Rs. 7.92 lakh crore ($126.63 billion) of assets under management of mutual funds (MFs) as on March 2015 and Rs. 3.57 lakh crore ($57.08 billion) of insurance premium collected in 2013-14. Yet, less than 5% of India's household financial savings of Rs. 8.19 lakh crore ($130.95 billion) was invested in the capital markets in 2013-14. There are three primary reasons for the abysmal level of interest: lack of awareness about financial products, market volatility, and a conservative mindset arising from low per-capita income. We believe it is in the nation's interest that we have long-term policies for channelling household savings into the capital markets.

Indeed, financial intermediaries and distributors will have a seminal role to play in fully realising that enormous potential. Today, the average working person, because of inadequate awareness and limited knowledge of investments, requires guidance and handholding. While the proliferation of internet helps many find answers to their investment questions, a good lot require the personal touch -- of a friend, philosopher and guide, as it were -- to wade through the complex world of investments and arrive at the optimal choice.

Developing a vast pool of financial advisors and distributors is thus an imperative. This also helps in employment creation and retail penetration, and thereby benefits the economy at large. And since the industry requires specific skill sets, it is equally important to put in place initiatives that will foster such human resource development. Existing distributors are expected to resort to digital distribution to grow the industry significantly and at the same time reduce costs.

Implementation of the Securities Exchange Board of India's move to bring in a self-regulatory organisation (SRO) for mutual fund distributors would aid the industry. Additionally, creation of a single SRO for the entire distribution industry will help monitor and regulate financial intermediaries. This body could establish best practices and guidelines for its members, while keeping the interests of investors in mind, helping drive financial penetration further and spreading investor awareness. However, recent changes in the mutual fund industry including the recently imposed service tax on MF distributor commissions, and distributor commission capping can be a major dampener for the MF and the distribution industry unless resolved soon.

High potential

Within the financial products universe, mutual funds have the potential to grow the fastest as investors move away from traditional products and explore market-linked ones for long-term wealth creation. The mutual fund industry has potential to grow at 23% annualised over the next six years to an asset size of Rs 37 lakh crore ($591.57 billion). This is likely to be supported by distribution channels, which are estimated to grow at around the same pace. The pace will be aided by an increase in penetration in order to meet the financial aspirations of the rising middle-class as well as capital market performance. Banks, both private and PSUs, are in a sweet spot to capture the large middle class population across geographies. Independent financial advisors (IFAs) and national distributors (NDs) through technology-enabled sub-broker models are expected to expand their reach and presence in the B-15 cities (non-metros) to capture the biggest chunk of this growth opportunity.

In the insurance industry, rise in penetration will be fuelled by increase in population, particularly the working age population, rising income levels, as well as other socio-economic factors such improvement in lifestyle, higher medical costs and nuclear family system. We estimate that although the Life Insurance Corporation of India (LIC) will continue to be far ahead of the private sector in terms of market share, the private sector will grow faster. Traditional products would continue to reign due to pricing disparity. Premium in life insurance is projected to more than double to nearly Rs. 9 lakh crore ($143.58 billion) by 2020 from Rs. 3.14 lakh crore ($50.20 billion) in 2014, while premium in the non-life insurance industry is presaged growing two-and-a-half times from Rs. 70,610 crore ($11.35 billion) in 2014 to nearly Rs. 1.8 lakh crore ($29.26 billion) by 2020.

As alternative investment funds (AIFs) and portfolio management services (PMS) are niche products, mainly targeting the high net-worth individual (HNI) and ultra-high net-worth individual (UHNI) segments, they form a small part of the overall product pie. India being a developing economy is yet to see significant investment flow in this category. This segment is likely to rise among private sector banks, boutique wealth management firms and national distributors due to the increase in HNI base at the end of 2020. However, this figure may likely be marginal compared with other products.

Key drivers

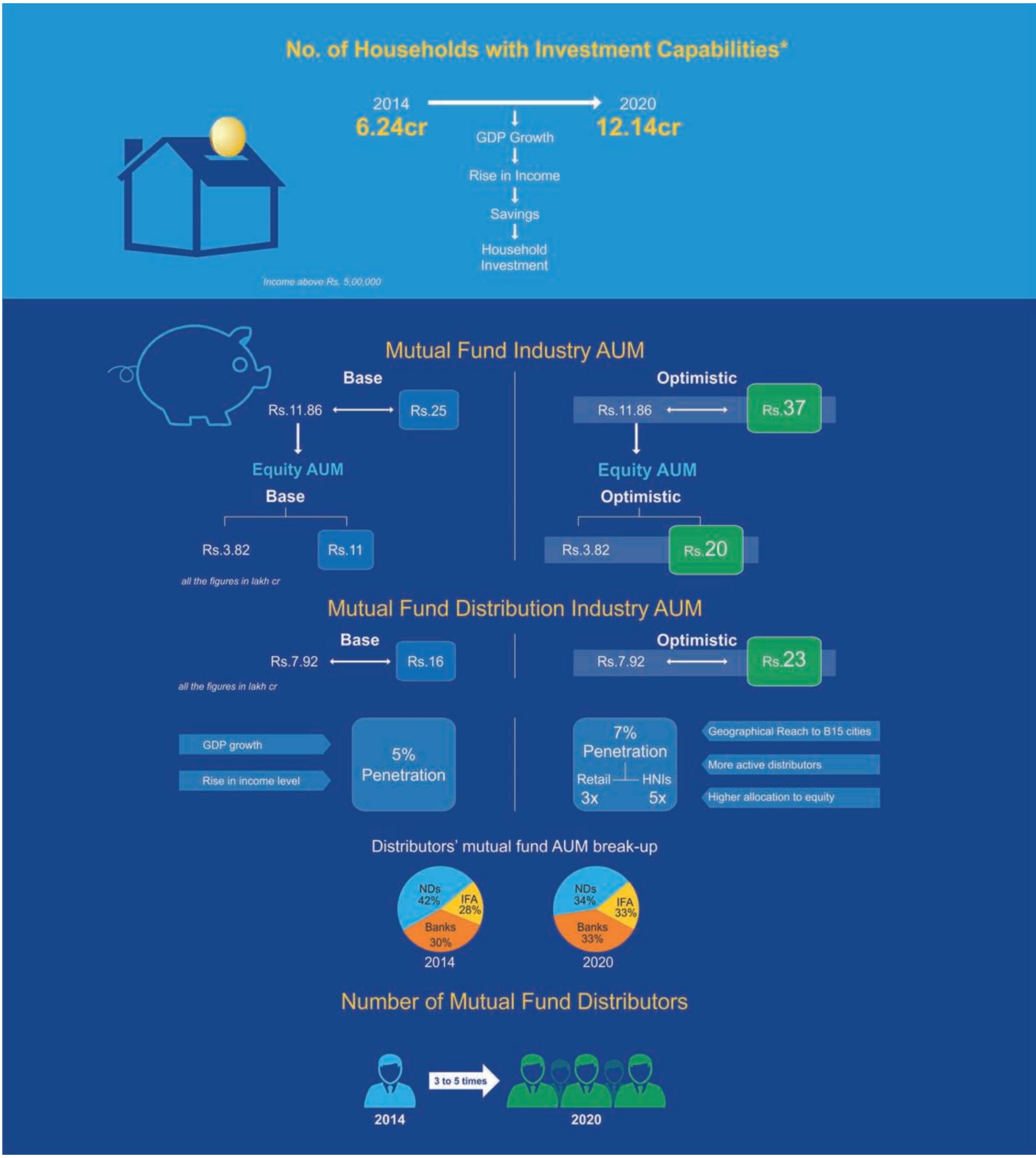
Hands on the deck: There has been a decline in the number of active distributors in recent years for both mutual funds and insurance. Retaining distributors and retail agents becomes a huge challenge for insurers in particular, considering they invest a lot on training. High level of churn affects long-term plans and costs of companies. With fewer players, the reach across different income and geographical segments is limited and penetration that much more difficult. We believe having players catering to multiple client segments will improve the economics of business. Skill enhancement and training would be imperative to expand the network of distributors. As such, the number of distributors should potentially grow by 3 to 5 times by 2020 to meet the industry potential.

Awareness: Low financial literacy levels and lack of awareness, unless addressed well, will inhibit the industry's growth. Financial products continue to be 'push' products in India and regular connect plays a huge role in fostering trust, retaining investors and attracting more investment. Asset allocation and financial planning help in goal planning and meeting various objectives. However, till such time investors remain unaware of such concepts, money will continue to flow into gold and real estate. Development of new distribution channels, government support through schemes such as the inclusion-driver Jan Dhan Yojana and greater focus on retirement planning through introduction of schemes on the lines of the 401(k) in the US will help the mutual fund industry realise its potential.

Business V iability: Rising employee costs (fixed and variable) and real estate prices also threaten the distribution industry's growth – particularly the national and regional players. The industry is currently grappling with changes in its business model, such as capping of commission and inclusion of distributors under the service tax regime, which could be a major dampener for the industry. This can affect players who haven't adopted a scalable model. While automation cuts costs, complex systems can add to costs when business plans are revised.

Technology: As investors become more tech savvy, the pace of integration of newer technologies will also become easier. Recent initiatives to extend financial inclusion through mobile banking and trading and initiatives to enable tablet-based investments are precursors to the great role technology will play in years to come. Appropriate technology can also help reduce transaction costs. A reduction in physical costs (paperwork, labour) enables the distributor to focus on value additions for the client, bring in efficiency of time and enable the distributor to increase volume. In addition, technology can play a major part in compliance of rules and regulations in maintaining up-to-date database in keeping with norms. Thus new-age technology models, with ease of transaction and better reporting, can lead to better results for industry growth by distributors.

Financial distribution industry at a glance



Lower Share of Household Savings

*2013-14

- Lack of Financial awareness
- Low Penetration
- Conservative mindset arising from low per-capita income

Insurance Industry Premium

Base

Rs.3.84 ⟷ Rs.8.79

Optimistic

Rs.3.84 ⟷ Rs.10.80

all the figures in lakh cr

Insurance Premium Under Distribution Industry

Base

Rs.3.57 ⟷ Rs.8.20

Optimistic

Rs.3.57 ⟷ Rs.10.05

all the figures in lakh cr

Annexure

Assumptions used for the projection in mutual fund and insurance industry in the report

	2014	2020		Remarks / Assumptions
		Base scenario	Optimistic scenario	
No. of households with annual income above Rs. 5 lakh	6.24 crores	12.14 crores	12.14 crores	CRISIL Research estimates
Retail Investor (household)				Individuals in the household where the household income is between Rs. 5 lakh and Rs. 1 crore
HNIs/UHNIs (household)				Individuals in the household where the household income is greater than Rs. 1 crore
Mutual Fund Investor base	1.3 crores	2.53 crores	3.56 crores	Based on the total folios in the industry as per AMFI where unique investor is arrived by assuming that on an average an individual investor has three folios and corporate/institutional investor has thirty folios
Assumptions for forecasting of assets under management for mutual funds	Rs. 10.51 crores	Rs. 25 lakh crores	Rs. 37 lakh crores	(i) Investor doesn't switch investments from one asset to another asset class and holds the assets for the next six years (ii) Ticket size is computed using average net inflows data over the past ten year period (iii) Investments grow as per the expected return from the equity (15.25%), debt (8.31%) and liquid (8.21%) asset categories (represented by 5-year returns of CRISIL-AMFI fund performance indices) over the next five years (iv) Mutual fund industry is able increase the corporate money in liquid funds. Annual net increase in the AUM of liquid funds is assumed at 1.46% (as per historical ten-year average)
Penetration in mutual funds	5.2%	5.2%	7.3%	Penetration is defined as no. of investors in mutual funds out of total no. of individuals in the households having annual income of more than Rs. 5 lakhs
Assumptions for Optimistic scenario in mutual funds				Higher penetration is achieved by doing the following: (i) Industry is able to capture the maximum out of rising middle class income group by doing what is required, such as reaching new cities (ii) Increasing the investor base through geographical expansion to B-15 cities along with greater penetration to T-15 cities (iii) rise in annual growth in the households numbers – retail and HNI segment by 12% and 21% respectively based upon CRISIL Research estimates (iv) 12% and 18% growth in annual investment amount (ticket size) in retail and HNI segment, respectively (v) Nearly 0.50% and 0.75% of existing retail and HNI individuals will be covered under distribution in addition to new investor base
Assumptions for Base scenario in mutual funds				The penetration level remains unchanged (i) The existing investors (retail and HNI) continue to invest in equity, debt and liquid mutual funds with 12% increase in ticket size for the next six years (ii) Investments through retail and HNI channel are estimated to grow at the rate of nominal GDP

	2014	2020		Remarks / Assumptions
		Base scenario	Optimistic scenario	
Revenue of the distributors in mutual funds	Rs. 2,581 crores	Rs. 9,500 crores	Rs. 21,000 crores	(i) The gross inflow during the year is assumed to be nearly 5 times of projected net inflow during the year under debt mutual funds and 2.7 times of the projected inflows during the year under equity mutual funds based on the past trends (ii) 55% of the total gross flow in debt mutual fund is through distributors (iii) 94% of the total gross flow in equity mutual fund is through distributors (iv) Distributor earns the upfront commission on the gross inflows during the year and trail commission is earned on the outstanding AUM at the end of previous financial year (v) An average upfront commission of 1.25% and 0.75%, each , is earned on equity and debt mutual funds; respectively (vi) An average trail commission of 0.50% and 0.40% is earned on equity and debt mutual funds; respectively
Insurance premium	Rs. 3.85 lakh crores	Rs. 8.79 lakh crores	Rs. 10.81 lakh crores	(i) GDP growth forecast for 2020 as per Central Statistical Organization (CSO) (ii) Premium projections of Life and Non-life are based on the Insurance Penetration - For optimistic case – the maximum penetration in the last 10 years is used - For Base case – the average penetration in last 10 years is used
Premium through distribution channel	Rs. 3.57 lakh crores	Rs.8.20 lakh crores	Rs. 10.05 lakh crores	The share of direct premium in the insurance industry continues to be at current levels
Commission earned by distribution channel	Rs. 25,470 crores	Rs. 54,000 crores	Rs. 66,000 crores	The average commission percentage charged to the premium stays at current level - 6.63% for life insurance premium - 6.55% for non-life insurance premium
Penetration in Life insurance	3.00%	3.63%	4.39%	
Penetration in Non-life insurance	0.67%	0.67%	0.90%	
Exchange rate used for INR to USD				US $1 = Rs. 62.55 (as on 31st March, 2015)

Acknowledgement

CRISIL and FIAI are grateful to CAMS for providing extensive information on mutual fund AUM. This research report would not have been possible without the data.

About FIAI

FIAI (Financial Intermediaries Association of India) is the premier trade body of Financial Intermediaries in India comprising Banks, National Distributors, Private Wealth Management Companies and IFA Associations. It is the Financial Distributors' body created to strengthen the cause, development, education and progress of the Distribution Industry.

FIAI's endeavor is to bring all the distribution players on one common platform to pursue the Industry Development, Issue resolution, Industry positioning & welfare. Its twenty four members are estimated to represent more than 60% of Industry's ARN holders (Mutual Fund sellers). The body has been in regular action like organizing Financial Literacy drives, conducting investor surveys, organizing own events, participating in important forums like being Industry support partner to Industry events, representing with SEBI, Ministry of Finance and AMFI through meetings & submitting white papers and various other activities.

Role of FIAI

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