NUST BUSINESS SCHOOL

Research Paper

Factors Hindering the Growth of Mutual Funds Industry in Pakistan

January 23, 2009

BBA-2K5

Mahwish Humayun
Muhammad Umar Malik

Table of Contents

1. Abstract

The paper seeks to examine the causes that have led to the phenomenal growth of the Mutual Funds industry in India while that in Pakistan remained somewhat throttled. Despite the two countries having started the industry around the same time with the same number of asset management companies today, the growth of India far exceeds that of Pakistan because of four specific factors: laws and regulations, demand-side factors, supply-side factors and trading considerations. The factors are studied in detail and the relationships established which explain the discrepancies. The analysis of the reasons for hindered growth of the Mutual Funds industry is followed by some recommendations which will help boost the growth in the industry and will make the Pakistani Mutual Funds market thrive.

2. Introduction

In this paper, we will attempt to gauge the various factors which have hindered the growth of Mutual funds industry in Pakistan and compare it with the factors/policies that have contributed to the phenomenal growth of mutual funds in other countries such as India.

2.1 Objectives

To carry out an in-depth analysis of the four sets of factors that influence fund investing and their impact on the growth of the Mutual Fund Industry:

- Laws and Regulations
- Supply-side Considerations
- Demand-side considerations
- Trading Characteristics

2.2 Significance of Study

The study of the factors that are hindering the growth of the Mutual Funds industry in Pakistan has enabled us to identify the reasons for the hampered growth and consequent corrective measures that need to be taken in order for the industry to flourish and thrive like it is doing world-wide.

2.3 Structure of the Paper

The paper begins with a look at the existing literature available on the topic and discussing their major findings, under the section "Literature Review". It then discusses the "Research Methodology" employed, followed by the "Analysis" of the various factors outlined and then ends with a summary of the findings in the "Conclusion".

3. Literature Review

In Pakistan, the industry portrays fund investors as diligent, fairly sophisticated, and guided by professional financial advisors. The industry claims that the result is a competitive mutual fund market as fund investors demand low costs and solid performance. The SEC's regulatory policy paints a more cautious portrait of fund investors. While acknowledging that many investors have limitations, the SEC touts improved disclosure by the industry as a sufficient antidote.[1] The academic literature, however, finds that fund investors are generally ignorant and financially unsophisticated. Most investors are unaware of even the basics of their funds, do not take costs (especially ongoing costs) into account when they invest, and chase past performance, despite little evidence that past fund returns predict future returns.

---

[1] http://works.bepress.com/ahmed_taha/1/

4. Research Methodology

We have formulated certain hypotheses regarding each of the four factors and then, through primary and secondary research, we have either proven or disproven these, hence, reaching a conclusive judgment about the effect of these factors on the growth of Mutual Funds Industry in Pakistan.

We've also spoken to some industry experts[2,3] and taken their opinion on the subject as part of the primary research. As with regards to secondary research, we have looked into existing literature which talks about the phenomenal growth of Mutual Funds in India as compared to Pakistan.

5. Analysis

In this paper, we study a combination of fundamental economic and regulatory forces that help explain where the open-end fund has flourished.

5.1 Factors affecting Growth of Mutual Funds Industry

At the outset of this analysis, it is important to appreciate that these are not mutually exclusive classes of hypotheses—rather, all may help explain the different patterns in the mutual fund industry.[4]

5.1.1 Laws and Regulations

One hypothesis, based on the literature on law and economics, is that laws and regulations can explain the differences in the pace of financial development from country to country. Applying this logic to the mutual fund industry, we can expect that funds would prosper when laws and regulations make this sort of investment attractive to investors, for example by protecting investor rights.

---

[2] Junaid Iqbal – CEO, BMA Funds
[3] Aun Rizvi – HBL Asset Management
[4] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=589202

In general, countries with stronger judicial systems, and more specifically, nations with more stringent regulatory approval and disclosure requirements for funds tend to have a larger fund industry. This latter result indicates that stronger regulation—that specifically protects fund investors—may be beneficial to the fund industry.

Furthermore, for equity funds, the enforcement of insider trading rules has an adverse effect on the size of the mutual fund industry, consistent with the view that failure to enforce these rules discourages investors from purchasing equities directly and encourages them to rely on professional intermediaries like funds instead.

5.1.2 Supply-side Considerations

Hypothesis: "Supply-side" hypotheses focus on competitive dynamics to explain different adoption rates. For example, a concentrated banking sector could plausibly encourage or discourage the formation of a strong fund industry, depending on whether banks saw the fund business as a complement or substitute to their traditional deposit-taking activities.

Observation: When considering supply-side factors, we study characteristics of the financial sector that would influence the speed of adoption of mutual funds. We examine the effect of bank concentration, restrictions placed on banks to enter the securities business, the number of distribution channels available for funds, the presence of an explicit deposit insurance system for banks, and the time and cost to set up a new fund. We find that nations that restrict banks from entering the securities business have smaller equity fund sectors, while countries with a more concentrated banking industry have smaller bond fund sectors. Nations where barriers to entry are higher have smaller fund industries; in particular, the costs required to set up a new fund are negatively related to industry size.

5.1.3 Demand-side Considerations

Hypothesis: A “demand-side” hypothesis focuses on characteristics of the potential buyers of mutual funds in terms of, for example, their degree of wealth and education, to explain these differences. We might expect that more economically well-off and sophisticated nations would be quicker to adopt the innovation in place of the older more opaque methods of investing.

Observation: When considering these demand-side factors, wealthier countries, measured by GDP per capita, and countries with a more educated population have larger mutual fund industries. These effects are particularly pronounced for the equity funds which may require a higher level of investor sophistication. Internet penetration is also positively related to the size of the mutual fund sector, but it is highly correlated with the other demand-side variables. The age of the national fund industry is also positively related to its size and recent growth rate.

5.1.4 Trading Characteristics

Hypothesis: Finally, the characteristics of the country’s securities trading environment may be relevant, in the sense that the production technology available to fund promoters can influence the attractiveness of the ultimate investment vehicle.

Observation: Countries where trading costs are lower have a more developed fund industry. This indicates that the ability to offer liquidity at a low cost is important for the industry’s growth. Overall, these results suggest that mutual funds thrive in more developed economies.

5.2 India and Pakistan; a Critical Comparison

5.2.1 The Indian Reality

Start: The Indian mutual fund industry started in 1963 with the formation of Unit Trust of India through the initiative of the India government and Reserve Bank of India. The first phase started from 1963 to 1987 in which Unit Trust of India (UTI) was established in 1963 through a Parliamentary legislation. At the end of 1988 UTI had Rs. 67 billion assets under management.

1967-1993: Private sector funds including non-UTI and public sector mutual funds set up by public sector banks, Life Insurance Corporation of India (LIC), and General Insurance Corporation of India (GIC) entered Indian fund industry during this phase. SBI Mutual Fund was the first non-UTI Mutual Fund established in June 1987 followed by Canbank Mutual Fund (Dec 1987), Punjab National Bank Mutual Fund (Aug 1989), Indian Bank Mutual Fund (Nov 1989), Bank of India (Jun 1990), Bank of Baroda Mutual Fund (Oct 1992). LIC established its mutual fund in June 1989 while GIC had set up its mutual fund in December 1990. At the end of 1993, the mutual fund industry had assets under management worth Indian Rs. 470 billion.

1993-2003: With the entry of private sector funds in 1993, a new era started in the Indian mutual fund industry, giving the Indian investors a wider choice of fund families. The number of mutual fund houses went on increasing with many foreign mutual funds setting up funds in India and the industry also witnessed several mergers and acquisitions. At the end of January 2003, there were 33 mutual funds with total assets of Rs. 1,218 billion. The Unit Trust of India with Rs. 445 billion of assets under management was way ahead of other mutual funds.

2003-onwards: In February 2003, following the repeal of the Unit Trust of India Act 1963, UTI was bifurcated into two separate entities. One is the specified undertaking of the Unit Trust of India with assets under management of Rs298 billion as at the end of January 2003, representing broadly, the assets of US 64 scheme, assured return and some other schemes. The specified undertaking of Unit Trust of India, functioning under an administrator and under the rules farmed by the Government of India does not come under the purview of the mutual funds regulations. At the end of April 08, Indian mutual funds industry was managing $129.40 billion.

5.2.2 The Pakistani Reality

Start: The mutual fund industry in Pakistan was introduced in 1962. National Investment Trust (NIT), launched in 1964, and Investment Corporation of Pakistan (ICP), a close-end fund launched in 1966 managing 26 funds were the two main heads traded in the market depicting government's monopoly in the mutual funds industry. However in Pakistan in 1971, the government allowed the private sector in the close-end segment but shorn off the right to float open-end funds due to the trepidation of the regulators that the private sector will not be able to manage the funds prudently. Abamco Growth Fund (formerly 4th ICP), (PICIC Growth Fund (formerly ICP-SEMF) and Golden Arrow respectively listed in 1970, 1980 and 1983.

1987-1993: During the 90's boom of the stock market where the government policies were relaxed for the private and foreign investors in the market. The first private sector open-end mutual fund UTP was launched in 1997 and the private sector fund managers formed the Mutual Funds Association of Pakistan (MUFAP), which was formed for self-regulatory purposes.

1993-2003: In Pakistan, due to the decent performance of the local exchanges the mutual fund industry grew in absolute terms. During the discussed period the mutual fund industry came in limelight at the local stock exchanges due to government's policies and incentives given to NBFCs. The number of Asset Management Companies (AMC) increased from 13 in FY99 to 18 in FY04. Growth in net assets of the mutual funds shot up by +510 per cent during FY99-FY04, period where net assets growth to GDP ratio, which was a mere 0.63 per cent in FY99 surged to 2.4 per cent in FY04 depicting the impact of economy and stock market on the financial base of the funds operating in Pakistan. Looking at FY99-FY04 performance of the mutual funds sector at the KSE, the market capitalization of the industry during FY99 stood at Rs. 3.1 billion, which boosted to Rs. 27 billion showing an upside growth of 8.7 per cent. This was mainly on account of investors' interest generated towards the mutual fund industry, which reported healthy profits offering good return to investors in terms of bonuses and dividends.

2003-onwards: In Pakistan, at the end of March 08, the total asset size of the mutual fund industry surged to Rs. 385.5 billion ($6 billion). The size of open-end mutual fund swelled to Rs. 331.6 billion at the end of Mar 08, however, the size of close-end mutual fund remained close to 54 billion.

Despite almost same number of asset management companies, the size of Indian mutual fund industry is 20 times larger than Pakistan mutual fund industry. It is due to number of potential investors, the general level of awareness and government role in policies which motivate to save rather than consume.[5]

[5] See Appendices A and B

6. Conclusion

It is incumbent on our policy makers and regulators to adopt a progressive and enlightened view of mutual funds and to take such measures as are necessary so as to enhance the effectiveness of the industry as an important pillar of the financial system.

There is no reason why in reference to bank reserve requirements, permissible provident fund investments etc, policy makers should distinguish between government securities and mutual funds accredited with high, investment grade, ratings. As far as possible, there should be a level playing field between investing in mutual funds and in Government Securities.

Policy makers should adopt cogent measures to promote the provision of pension and retirement benefits to a substantial part of the population and clearly this would not be feasible without the involvement of competent fund managers.

Regulators must pro-actively encourage innovation and new product development, and the promotion of mutual funds based on such products, as well as asset classes like derivatives, commodities or real estate, and also viable schemes to extract value from special situations that can be rolled out for investment by retail investors through the mutual fund structure.

Within certain reasonable, prudential parameters, mutual funds should be allowed to hedge their positions through the use of derivatives, borrow and leverage their positions, sell short, lend securities, and also buy back their own certificates in the open market. At present, mutual fund managers are handicapped by the inability to do all this. As a consequence, management of a fund's portfolio suffers and this is reflected in the price of the fund's certificates.[6]

Some form of accountability of fund managers to the fund certificate holders should be introduced through structures such as the convening of annual meetings of certificate holders, establishing advisory boards, or through other suitable ways. The code of conduct for mutual fund managers may need to be strengthened in line with international best practice. In particular, mutual fund managers need to adhere to sensible guidelines regarding representation in annual meetings and boards of investee companies, grant of proxies etc. Furthermore, most importantly, compliance procedures need to be strengthened with, among other matters, the appointment of independent compliance officers reporting directly to the Board.

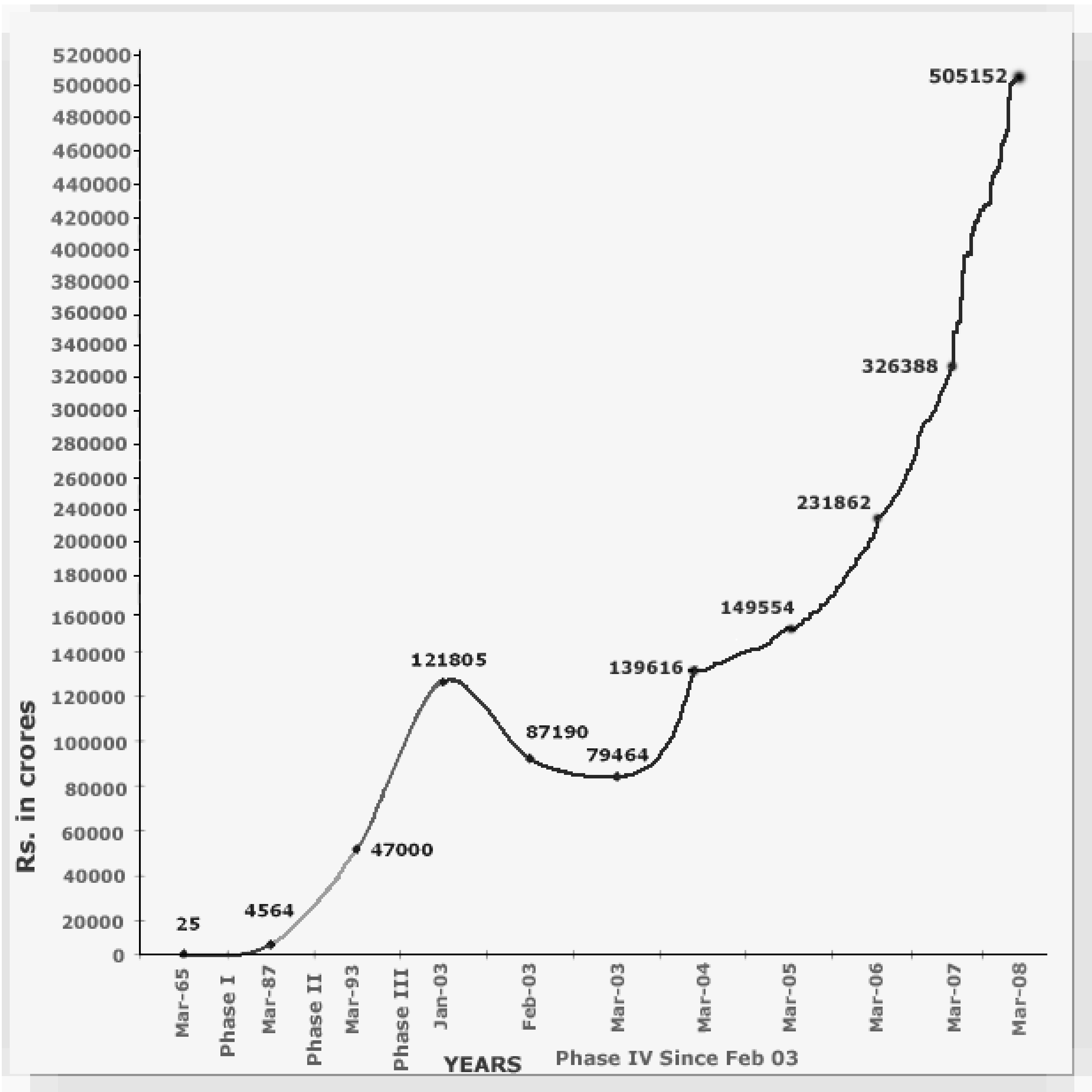
There is no harm in permitting dedicated mutual funds catering to sophisticated investors only e.g. large institutional investors. It should be possible to permit the setting up of such mutual funds without prior regulatory approval, with only registration being required under a somewhat light regulatory regime. Savvy fund managers will thus be able to acquire large amounts to manage and reap the benefits of economies of scale. Some professionals may even be able to start business by setting up such mutual funds, and having gained the necessary experience, move on to managing the usual retail mutual funds.

____

6 http://thefinancialdaily.com/Articles/ViewArticleDetail.aspx?ArticleID=2563http://www.mufap.com.pk/Khalid%20A.%20Mirza%20Key%20Note%20Speech.htm

APPENDICES

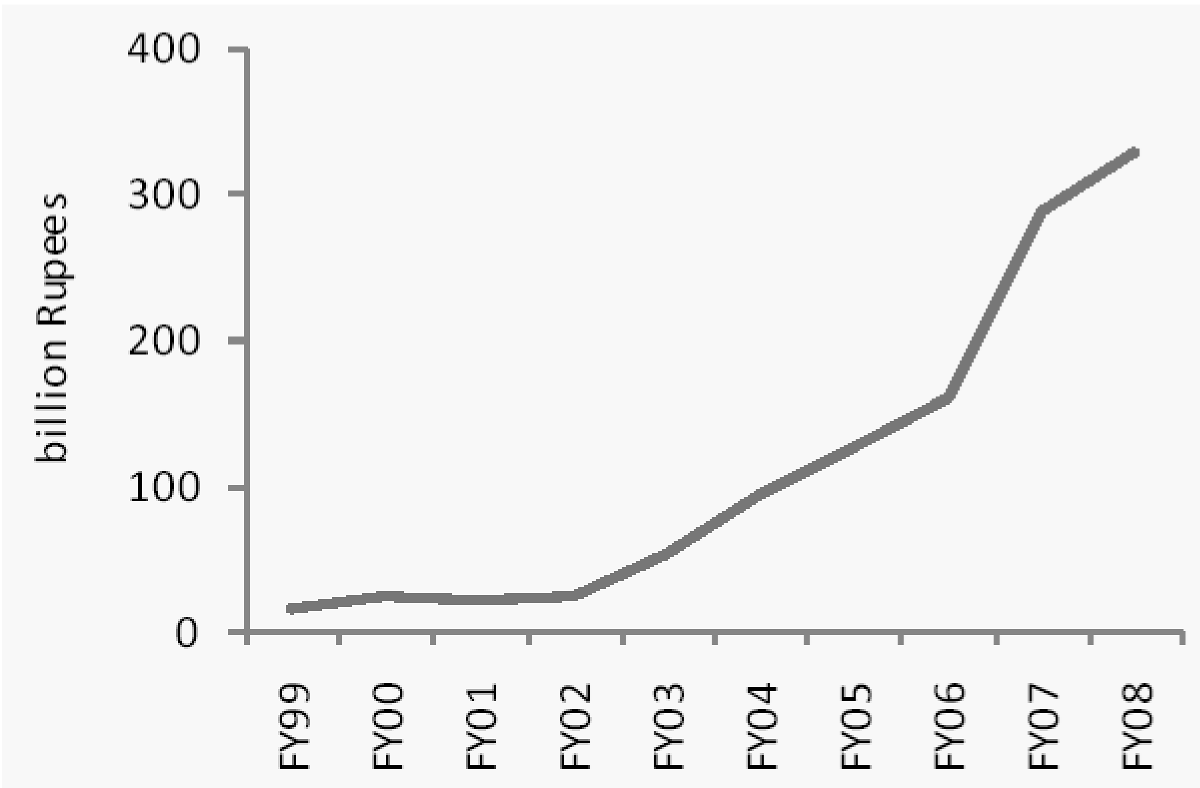
APPENDIX A: Assets under Management in the Mutual Fund Industry in India[7]



---

[7] http://www.amfiindia.com/showhtml.asp?page=mfindustry

APPENDIX B: Assets under Management in the Mutual Fund Industry in Pakistan[8]



[8] http://www.sbp.org.pk/FSR/2008/PDF/Chapter%2010%20Special%20SectionProfile%20of%20Mutual%20Funds.pdf