

## TECHNICAL ASSISTANCE COMPLETION REPORT

Division: SARD/INRM

<b>TA No. and Name</b> TA 4010-IND: Reform of the Mutual Funds Industry		<b>Amount Approved:</b> \$800,000	
		<b>Revised Amount:</b>	
<b>Executing Agency:</b> Ministry of Finance, Department of Economic Affairs (Capital Markets Division)	<b>Source of Funding:</b> TASF	<b>Amount Undisbursed</b> \$205,653.34	<b>Amount Utilized</b> \$594,346.66
<b>Dates</b>		<b>TA Completion Date</b>	
<b>Approval</b> 4 Dec 2002	<b>Signing</b> 27 Feb 2003	<b>Original</b> 31 August 2003	<b>Actual</b> 31 March 2005
<b>Fielding of Consultants</b> 29 July 2003		<b>TA Account Closing Date</b>	
		<b>Original</b> 31 August 2003	<b>Actual</b> 30 June 2005
<b>Description</b>			
<p>1. In 1993, Securities and Exchange Board of India (SEBI), the implementing agency (IA) for the Technical Assistance (the TA) had formulated a comprehensive regulatory framework to govern all mutual funds except Unit Trust of India (UTI), which paved the way for the entry of private sector mutual funds. As a consequence, the total assets under the management of mutual funds grew from Rs360 billion (\$8.18 billion equivalent) in April 1992 to Rs1.08 trillion (\$24.5 billion equivalent) in August 2002. However, a downturn in the capital markets and disclosure of mismanagement of funds in UTI, specifically under the Unit Scheme of 1964 eroded investor confidence and the growth in mutual funds slowed down drastically. The Government of India (GOI) recognized the need for a strong governance and regulatory framework for the mutual funds industry in order to restore investor confidence, and the importance of an enabling environment to promote the growth of mutual funds. The TA was in support of GOI's initiatives to enhance the role of mutual funds in developing long-term sources of funds.</p>			
<b>Objectives and Scope</b>			
<p>2. The objective of the TA was to assist GOI in enhancing the role and promoting the growth of the mutual funds industry as a key institutional investor in the capital market. The scope of the TA covered three major areas: (i) enhancing corporate governance in mutual funds operations, including the establishment of appropriate checks and balances, disclosure and reporting for mutual funds offering, valuation methods and performance measurement; (ii) strengthening regulations as well as enforcement and investigative capabilities of the regulator, particularly in dealing with malpractices; and (iii) recommending appropriate incentives and other necessary supportive facilities for promoting the growth of the mutual funds business.</p>			
<b>Evaluation of Inputs</b>			
<p>3. The scope of the TA was adequate and the consultants Terms of Reference (TOR) adequately covered the TA objectives. The TA was completed within the allocated timeframe of about 29 person months (18 person months - international consultants, 11 person months - domestic consultants). The performance of the TA consultant was satisfactory, with the TOR satisfactorily addressed. The executing agency (EA) for the TA was actively involved in the TA execution by assigning its staff to the project and providing regular support and feedback to the consultants. The Asian Development Bank (ADB) fielded an Inception Mission, participated in the workshop, and seminar organized by the consultants, besides interacting regularly with the consultants, the IA and the EA. The consultants submitted the reports within the envisaged timeframe. However, the EA requested for additional work under the TA, as a consequence of which an extension of the TA completion date was considered necessary.</p>			
<b>Evaluation of Outputs</b>			
<p>4. The consultants reviewed the existing corporate governance, regulatory, and supervisory framework applicable to the Indian mutual funds industry. They conducted (i) a workshop on international malpractices, methods of investigating such practices, and the current SEBI enforcement issues that was attended by 13 SEBI staff; (ii) a study tour for six key participants from GOI and SEBI to the United Kingdom to familiarize the</p>			

participants with the mutual funds industry there with specific emphasis on legal and operational issues related to professional corporate trustees; and (iii) an industry forum wherein the draft recommendations on various issues were shared with the various stakeholders in the mutual funds industry to gauge their feedback on the same. The consultants also prepared a model framework governing three interrelated areas: (i) registration and operation of mutual funds; (ii) licensing and conduct of business of asset management companies; and (iii) licensing and conduct of business of professional corporate trustees. Such a framework can serve as a starting point for drafting a full set of revised regulations.

5. The EA appreciated the consultants' performance and found the final report useful. It further requested ADB to appoint a tax expert to advise on various alternate tax structures for mutual funds, which could help in the rapid development of the mutual funds market. Ernst and Young (E&Y) were appointed as tax consultants under a subcontract with the TA consultant. The EA appreciated the report submitted by E&Y.

### **Overall Assessment and Rating**

6. The Project was intended to assist GOI in enhancing the role and promoting the growth of the mutual funds industry as a key institutional investor in the capital market. The expected outputs of the TA were to cover three areas: (i) improvement in mutual funds governance; (ii) strengthening of the regulatory and supervisory framework of mutual funds operations as well as enforcement and investigative capabilities of the regulator; and (iii) an appropriate incentive structure to promote investments in mutual funds. ADB provided regular feedback to the consultants and held consultations with both the IA and the EA for effective implementation. The EA involved itself actively in the implementation process and provided all the counterpart support to the consultants resulting in effective implementation of the project. As mentioned under paragraphs 4 & 5 above, project outputs met with expectations. Overall, the project can be rated successful.

### **Major Lessons Learned**

7. The success of the TA is attributable to both the theoretical sophistication and practical multi-country experience of the consultant. The consultants broad experience and extensive knowledge were demonstrated in the quality of presentations of the mid-term and final reports to a wide spectrum of market participants, which were convincingly delivered and generally appreciated. This TA also benefited considerably from the close involvement and commitment of the EA, which led to strong ownership of the project and assisted smooth implementation. The TA, however, could have achieved rather more (i) if SEBI had been more cooperative, rather than view the TA as an implied criticism of their opposition to Self Regulatory Organizations (SROs) for funds or fund managers; and (ii) if broader defined TOR were used that would have allowed better flexibility in project implementation.

### **Recommendations and Follow-Up Actions**

8. The Indian mutual fund market is extremely short term in nature and dominated by corporates, which accounts for between 60% to 80% of total value of assets under management in mutual funds excluding UTI. The way income from mutual fund investments are presently taxed exacerbates the tendency for short-term investments in mutual funds, which is not healthy for the growth and development of the industry. Accordingly, the Ministry of Finance has shown interest in the project outcome inter alia on the taxation. The TA emphasizes the need of establishing and maintaining a consistent fiscal policy for mutual funds and reforming both the accounting treatment of mutual funds and their taxation to enable tax-efficient retention of capital gains and reinvestment income with the principle of 'fiscal neutrality', to encourage a longer term perspective. The TA recommends that a special working group on mutual funds taxation should be formed comprising the taxation authorities, mutual funds tax specialists and auditors, Association of Mutual Funds in India (AMFI), and SEBI as the regulator, to identify detailed changes and timing of such changes that would be needed to bring about the above, particularly changes in fund accounting and procedures to facilitate the change in taxation as well as taxation authority practice. Given the importance of the special working group in the context of facilitating reforms in the mutual funds industry, it is recommended that ADB further assist GOI to establish the special working group in the near future.

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