Risks in Mutual Fund Business

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1. Introduction

Mutual Fund (MF) is basically a mechanism of pooling together the savings of a large number of small investors for collective investment, with a common financial goal.

India has a strong and a rapidly growing mutual fund industry over the recent years. Since the 1990's when the mutual fund sector was liberalized, the industry has traversed a long path, adapting itself continuously to the regulatory changes and investor preferences. The industry has grown from a single entity in 1963 to 43 mutual funds recently.

The AUM of the Indian MF Industry has increased from ₹4.13 trillion as on 31st December 2008 to ₹22.86 trillion as on 31st December, 2018, about 5 ½ times increase in the span of a decade. The total number of accounts (or folios as per mutual fund parlance) as on December 31, 2018 has crossed a landmark of 8 crore and stood at 8.03 crore (80.3 million).

The below image provides a bird's eye view of the mutual fund functioning.

2. Regulatory Framework

- *Securities and Exchange Board of India (SEBI)*

The regulatory body authority, namely, the Security Exchange Board of India (SEBI) was established in 1992, that regulates and supervises the mutual fund industry in India for establishment of sound and stable financial system, protection of mutual fund unit holders, market efficiency, privatization and opening of markets, etc. All Asset Management Companies (AMCs) have to be approved by SEBI for managing the investments. The Securities and Exchange Board of India (Mutual Fund) Regulations, 1996 ('MF regulations') govern, inter-alia, the establishment and operation of mutual funds in India. The provisions of the MF Regulations are administered by the SEBI. Mutual funds in India are setup as a trust under the Indian Trusts Act, 1882.

With the introduction of MF guidelines in 1992, all MF's were brought under a common regulatory framework to ensure greater degree of transparency and to take care of interests of investors. SEBI regulates the entire framework of operations and have provide guidelines with respect to, launch of funds, advertisement code, code of conduct, employee dealing, NAV computation and accounting, portfolio restrictions etc. all to ensure that the investors interest is protected.

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- *Association of Mutual Funds in India (AMFI)*

  AMFI is the industry body dedicated in the development of the Indian mutual fund industry. It helps in upholding high standards of integrity, professionalism and ethical conduct amongst the mutual fund players. The primary interest being to support SEBI in its cause to protect and promote investors interests.

  AMFI, the industry association of all SEBI registered mutual funds was incorporated on August 22, 1995, as a non-profit organization. As of now, all the 43 Asset Management Companies that are registered with SEBI, are its members.

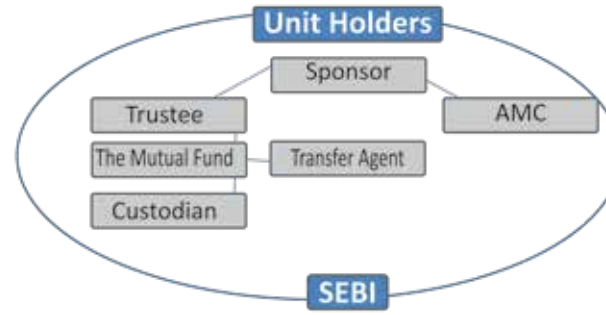
  Mutual Funds are highly regulated to overcome conflict of interest of investor and Fund Manager. Such conflict of interest can compromise the interest of investors and expose them to risk of poor portfolio selection, higher churning leading to higher operating cost, higher portfolio risks than indicated in the Scheme Information Document. It may also result in risks such as delayed settlement of transactions.

3. Structure of a Mutual Fund

A. Framework of a Mutual Fund

As explained earlier, Mutual Fund pools together the savings of a large number of small investors for collective investment, with a common financial goal.

The funds accumulated are invested in various asset classes such as, money market instruments, corporate bonds, listed and unlisted securities, gold, exchange traded instruments etc. The revenue generated from such investments and capital appreciation on such investments is accounted for by the funds and shared amongst the investors (unit holders) of the funds in the proportion of the units held by them. Mutual Fund offerings help in investing in a well-diversified professionally managed portfolio of securities at a relatively lower cost.



a. **Sponsor -** The Sponsor(s) as per the MF regulations "means any person who, acting alone or in combination with another body corporate, establishes a mutual fund". The sponsors are those who setup the mutual fund Trust, the Asset Management Company (AMC) and bring in capital.

b. **Board of Trustees or Trustee Company -** The Trustees of a Mutual Fund could be constituted as a 'Board of Trustees' or could be incorporated as a 'Trustee Company. The Sponsor appoints the trustees for the mutual fund. Trusteeship fees are paid by mutual fund schemes.

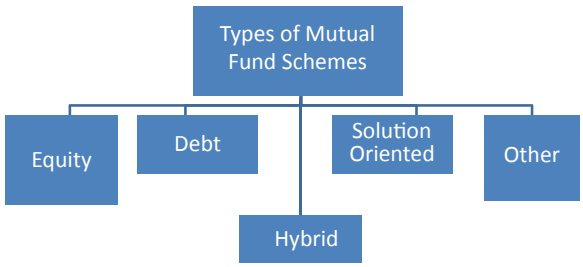
c. **AMC -** The AMC is the entity that manages the pooled fund contributed by the investors. The Trustee's or the Sponsor delegates the investment management function through an investment management agreement for a management fee. The AMC is responsible to launch funds, comply with regulatory framework, manage the overall schemes and funds of the mutual fund. The AMC also appoints engages other service providers to facilitate the functioning of the fund.

B. Mutual Fund Schemes

There are various types of schemes that a mutual fund provides typically these are

either open ended or closed ended. Within these the schemes have different investment patterns generally categorized as equity, debt, money market / liquid, arbitrage, index, sector, fund of funds, Exchange traded funds etc.

SEBI in 2017 introduced a guideline to bring rationalisation and consolidate mutual fund schemes to bring uniformity, avoid confusion of the various offerings by the mutual fund. The funds have to be categorised amongst the 36 categories provided within 5 broad parameters viz., equity, debt, hybrid, solution oriented and others.



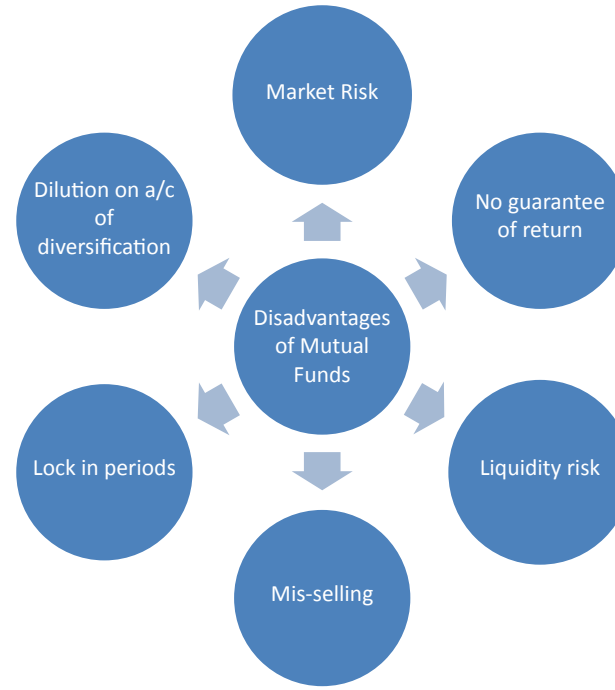
Large cap, Mid cap, Small cap etc. are the examples of Equity schemes. Overnight fund, Liquid Fund, Ultra Short Term Duration Fund etc. are the categories of Debt Fund. Dynamic Asset Allocation, Arbitrage, Equity Savings are the categories of Hybrid Fund. Retirement Fund and Children Benefit Fund are the Solution Oriented Schemes. Index Funds, Exchange Traded Fund (ETFs) and Fund of Fund are the categories of other type of schemes.

As per the said circular, only 1 scheme per category has been permitted by SEBI except for Index Funds, Fund of Fund scheme and sectoral or thematic funds.

4. Advantages and Disadvantages of Mutual Funds

Advantages of Mutual Funds

Disadvantages of Mutual Funds



5. **Governance of Mutual Funds**

Mutual Funds are registered under Trust Act, 1882. Mutual Funds are highly regulated by SEBI in order to ensure that the investors interest is protected. Consequently, various regulations are formed to ensure that there is a strong governance framework including setting up of separate entities within the overall structure of the Mutual Fund. It also requires that the Board of Trustees have at least 2/3 Trustees that are independent of Sponsor or its affiliates. Similarly, the AMC Board of Directors need to have at least ½ of its Directors independent.

Additionally, approval of unit holders of the Trust is required for bringing any changes to the attributes of the schemes. SEBI (Mutual Funds) Regulations also provide for winding up of a scheme of a Mutual Fund in specific circumstances subject to fulfillment of certain conditions.

6. **Risk Management System in Mutual Funds**

In the world of investment and return on investment, the term 'risk' is inseparable from performance and is simply necessary. In common parlance, risk defines the idea of no pain no gain.

"Mutual fund investments are subject to market risk, please read the offer document carefully before investing."

We all might have heard this statutory warning, stipulated by SEBI, to carry in every product documentation, advertisements now and then.

Have you ever thought about the risks associated with the mutual fund? Over the years, SEBI has strengthened the mutual fund regulations in order to minimize the risk, but it is rather impossible to avoid the risks of all kinds.

In fact, risk is in every business, but, not every industry stipulates a warning message to its customer upfront as a part of the sales package. For example, when you buy a cosmetic product there is a risk of an allergy or reaction but no such warning is stipulated in its advertisements. Almost all cola drinks have an impact on a customer's health and are considered unhealthy but no such warnings are stipulated.

The most important and crucial aspect in asset management is the task of managing risks. Mutual funds have grown notably over the years across the world. This has only been achieved by managing the interest of the investors and upholding the trust of efficient and effective management including the risk and returns of the pooled funds.

AMC's have been able to attract investors by investing the money responsibly, building a good track record of risk and returns and being transparent in administering the overall affairs of the mutual fund. Hence, it is critical for the AMC to have effective risk management framework and practices.

Investment Managers have to deal with a variety of risks viz., regulatory, counterparty, credit, reputation, market, operational and so on. Regulatory Risk refers to the change in regulations affecting the industry, security or fund. Counter party and Credit Risk refers to the risk of loss due to a default by the borrower in fulfilling its commitment. Reputation Risk in simple terms means threat to the goodwill of the company. Market Risk refers to the adverse movement in market prices including unpredictable changes in interest rates, fluctuations in exchange rate. Operational Risk refers to failure in operational processes;

Risk Management Process

Businesses are prone to risks. Risks in business cannot be completely eliminated, however

steps can be taken to manage the risks. Risk Management is a combination of processes involving identifying potential risks, assessing its magnitude, estimating controls to mitigate risks, evaluating effectiveness of controls to cover identified risks in order to achieve the objectives of the organization.

Risk management is an ongoing and permanent process. Typically risk management process comprises of objective setting, identifying the risks for the said objectives and measuring its criticality, identification and implementation of controls to mitigate the risk, assessing effectiveness of controls and ongoing monitoring & reporting of the movement of risks.

Mutual Fund's aim is to maximize performance of schemes at acceptable level of risk. To achieve this, objectives are set at the individual scheme level. Risk identification helps to find factors which can prevent the scheme from achieving its individual objectives which will also result in failure of the mission of the Mutual Fund. [1]

In applying the risk management process, a mutual fund scheme may establish various objectives and goals e.g. to maximize return on investment in the scheme, to safeguard investor's interests within scheme mandate, to maintain a certain degree of investor servicing, to make sure that assets in mutual fund business are safeguarded, to ensure that all relevant laws are being complied without any deviation, to preserve the name and repute of the mutual fund etc.

In order to achieve all such objectives, it becomes imperative for the fund house to ensure that all the operating procedures and controls covering identified risks are effectively.

Risk dimensions may vary depending upon various factors. Risks can be connected to each other or overlapping with other risks. Although the source of the risk remains the same, the nature and the type of risks emanating from such source may differ. The outcome of all such risks may vary in each case. Therefore, a Mutual Fund should identify and assess the potential impact of not achieving objectives of the scheme mentioned in its Scheme Information Document and accordingly design and implement controls to manage such risks.

Mutual funds in India are highly regulated. SEBI (Mutual Funds) Regulations, 1996 provide for the code of conduct to be strictly abided by AMC. Further, Trustees are entrusted with the responsibility to monitor whether the required level of due diligence is exercised by the AMC. AMFI on SEBI's advice had formed a Committee to study the current system of risk management and mutual fund's current practices on risks management. SEBI vide circular dated September 30, 2002 provided the risk management framework for Mutual Funds.

The said SEBI Circular giving the risk management framework intends to serve as a model which will

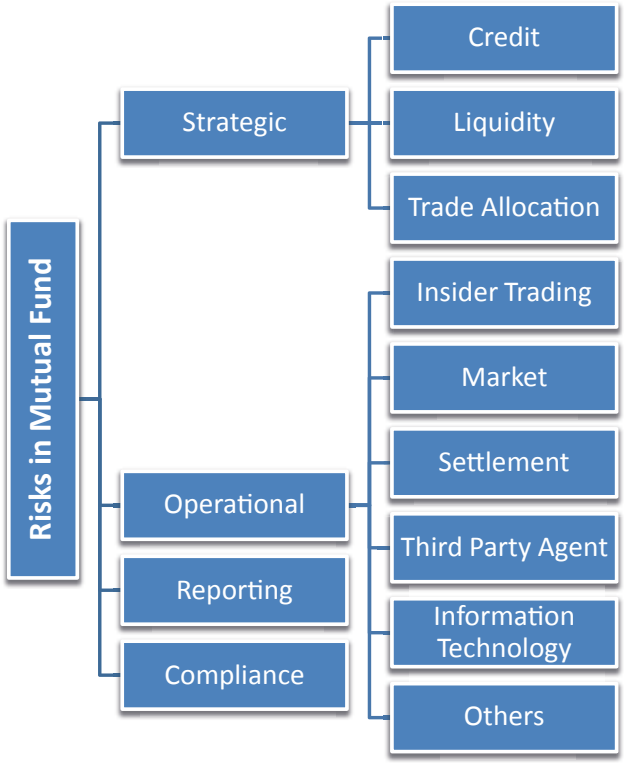
help Mutual Funds to monitor and mitigate risks, and to create value for business and investors. The Risk Management Framework is broadly categorized into 3 parts:

- Mandatory
- Recommended Best Practice and
- Existing Industry Practice

The following areas of mutual fund operations are covered in the risk management framework:

- Fund Management
- Operations
- Customer Service
- Sales and Marketing
- Other Business Risks

The risks identified in these areas are divided in three dimensions i.e.: policies and procedures, systems and organization. Also, additional risk measures have been prescribed in order to cover specific risks involved in each of these areas.,



Strategic Risks

1. **Credit Risk –** Credit risk arises when any committed debt payment by a borrower is defaulted. For e.g. A mutual fund scheme invests in a debenture or a bond with a specified maturity period with a fixed or variable rate of interest due at a defined frequency or date. When the issuer does not manage to pay either the interest or the principal amount on maturity period the scheme faces credit risk. Also, even when there is no default, the price of a security may change with expected changes in the credit rating of the issuer. Credit risk deals with the absence of intention of the counterparty to pay the dues.

   Credit risk and rating of debt securities have inverse relationship. Low credit rating suggests higher risk attached to the debt instrument. Also, the risk and return has inverse relationship. Higher risk means more return. Default in repayment for a debt security may lead to downgrade in rating which will result in increase in yield and fall in its price.

   Credit risk can be managed by exercising due diligence in security selection and diversifying the portfolio of the scheme.

2. **Liquidity Risk -** These are market events that cause excessive strain on the treasury of the fund house resulting in mismatch of cash flow. They lead to unexpected high value redemptions causing liquidity crunch. Liquidity risk occurs when securities within the portfolio can't be sold when required at the desired price.

   In mutual funds, liquidity risk generally arises due to huge redemptions. At such times if the mutual fund scheme holds securities which are thinly traded or not listed then, it becomes difficult for the scheme to sell the securities and generate cash for managing redemptions.

Liquidity risk can be mitigated by diversification of portfolio, exercising due diligence.

3. **Trade Allocation Risk –** The manner in which the common trade transactions are allocated among schemes poses a risk.

Operational Risks

1. **Front Office and Insider Trading -** Front Running by dealer may result into reputational risk and financial loss to AMC. It may also include leakage of sensitive information to insiders or breach of investment restrictions / norms.

   Insider trading in a mutual fund refers to making use of available non-public key information on portfolio dealings of the mutual fund scheme(s) to trade and achieve personal gains.

   The risk of front running and insider trading can be mitigated by restricting the personal mobile phones inside the dealing room, recording the landlines of dealing room and securing the chat messages.

2. **Market Risk -** Market risk refers to the movement in prices including unpredictable changes in interest rates, fluctuations in exchange rate. Market risk refers to appreciation or deprecation in value of securities due to market movement and change in share prices. There are a lot of factors which affect the market. Share prices in the market may get affected due to changes in political conditions, fall in economy, natural calamity, terrorist attack, inflation etc.

   Market risk can be of the type price risk, interest rate risk, inflation risk, sociopolitical risk, currency risk and country risk.

   Market risk can be managed by diversification of portfolio. Hedging can be one of the best way to counter market risk.

3. **Settlement Risk -** Settlement risk means the counterparty does not settle the deal. In equity shares, stock exchange mitigates the counterparty risk. However, debt securities carry the risk of settlement i.e. the counterparty may fail to deliver the security on the value date. Settlement risk can impact the churning of portfolio and result in downward movement of net assets.

   Settlement risk can be mitigated by involving a third party guaranteeing the performance of agreement.

4. **Third Party Agent** – Investor information may be shared with third parties for personal or professional gain. This may lead to operations of the AMC getting affected and loss to AMC.

5. **IT Risks -** IT risk is threat to data, critical systems etc. IT risks refers threat to data and security due to virus attacks, processing incorrect data on account of a human error, spam mails or phishing attacks, data becomes unusable for reading or any other usage, unauthorized access, absence of disaster recovery (DR) / business continuity plan (BCP), limited audit trails, etc. There also involves specific or targeted criminal threats from hackers, computer frauds, sharing of passwords and using someone else's password to steal critical information.

   With the advent of technology while it has eased a lot of aspects, if technology fails, business halts. Therefore, it is important to have a continuity plan in place. The plan should specify getting back to business in case of unwarranted service failures.

6. **Other Risks -** Computation of incorrect Net Asset Value (NAV - NAV is the price of per unit of mutual fund scheme), management override (ability of management to manipulate controls and achieve personal gains. It mainly relates risk of mis-statement of financial accounts), employee frauds including collusion and conflicting functions, fraudulent financial reporting, misfeasance by brokers, business continuity and disaster recovery etc.

Reporting Risks

It may include publishing of incorrect Net Asset Value (NAV) by Mutual Fund. Also, SEBI mandates various reports to be submitted at a predefined frequencies.

Compliance Risks

Compliance risk refers to the change in regulations affecting the industry, security or fund. It includes non-adherences with regulatory and internal requirements leading to a loss of reputation and loss of investor confidence. Non-compliances encompass investment risk, risks related to onboarding of investor etc. Violations of legal requirements may result in penalties and fines and put the reputation of the organization at risk.

To summarize, risk management at mutual fund and AMC is an ongoing and continuous process. It becomes important to identify all possible risks and implement controls to mitigate such risks. The mutual fund and AMC should have encompassing policies and procedures. It should also put in place strong computer systems and network to process transactions. It may not be possible to completely eliminate all risks in mutual funds, however risks can be managed effectively and mitigated.

Trustees in mutual funds have a fiduciary role to protect the interest of investors. Trustees shall ensure that AMC conducts its operations diligently. In order to ensure that AMC practices are in line with expected due diligence standards, it is imperative to have strong and extensive risk management practices.

Investors should not select schemes basis past returns but, basis specific parameters such as long term goal, risks involved, consistency of performance of the scheme, expense ratio of the scheme, lock in period, risk management practices, set processes, systems, reputation etc.

Pilot Project on Centres of Financial Literacy (CFL)

A hub-and-spoke approach to strengthen the financial capabilities of communities has been adopted wherein CFL function as a hub for training and learning, creating trained human resources from communities within the block. Subsequently, these trained human resources drive outreach in their respective communities as spokes.

NGOs work with low income communities to build their financial capabilities. The trainers and community financial health workers engage with the community and deliver financial education. *Anganwadi* teachers, *Asha* workers and self-help group leaders who demonstrate good communication skills are recruited from amongst the community. Peer learning and participatory learning methods are among the key components of the pedagogy.

A mass awareness campaign is initially conducted targeting 100 people in a village. Subsequently, interested participants are divided into batches of 25 and focused 3 day training programmes are conducted for these participants for about 3-4 hours per day. This reinforcement helps the participants build knowledge and skill to choose appropriate financial products and services.

As a first step, influencers, *viz*., members of SHGs, farmers federations, *panchayati raj* institutions and health workers are identified and named as "Change Agents - CAs". They are then nurtured and equipped with knowledge, and ways of behaviour change, through a series of multiple and repeated literacy sessions.

A suitably designed digitally equipped vehicle is being utilised to reach out to ensure that both illiterate people and people in far-flung areas are targeted. This Digital Financial Literacy Vehicle contains financial literacy material, audio/video (power point, demo equipment, *etc.*) and is managed by a block counselor.

Source : Reserve Bank of India, Annual Report 2017-18.