



CEO Review

Ms. Mashmooma Zehra Majeed, CFA, FRM
Chief Executive Officer, Mutual Funds Association of Pakistan

Economic Review

As per the Economic Survey of Pakistan, the country has recorded 5.28% GDP growth during FY17 versus 4.3% in FY16 as against the target of 5.7%, taking the economy beyond US\$ 300 billion. Despite missing the target, the GDP growth is highest in the last one decade. The current account deficit during July-Apr, FY17 reached \$7.247 billion (2.38 percent of GDP) as compared to \$2.378 billion (0.85 percent of GDP), thus widening by 204.8%.

The inflation in FY2016-17 clocked at around 4.2%, lower than the expected target of 6% mostly because of the low oil and commodity prices.

Savings and Investments

National savings plays a dominant role in achieving desired level of investment to reach the planned target of economic growth. National savings reduced to 13.1% of GDP in FY2017 against 14.3% last year. Domestic savings were recorded at 7.5% of GDP in outgoing fiscal year as compared to 8.2% of GDP last year. This is extremely low as compared to the region and the world and indicates that rigorous steps are required to promote savings and investments with major focus on investors' awareness and education as well as removing the taxation anomalies and regulatory issues hampering the growth. The Government needs to take measures on a priority basis to incentivize the long term savings.

Capital Markets Review

Equity

KSE-100 posted a return of 23.24% in FY17 as compared to 9.84% return in FY16. The major excitement during the fiscal year was the inclusion of Pakistan's reclassification into an MSCI Emerging market, from a Frontier



Markets. KSE-100 touched its all-time high closing of 52,876 on May 24, 2017 (touching an all-time intra-day high of 53,127 on May 25, 2017). That marked the peak from which the index came crashing down as reality set in terms of heightened political uncertainty, pressure on USD/PKR parity due to worsening external accounts and an unfavorable stock-market budget. Meanwhile Pakistan performed the worst in MTD return charts and was an underperformer in the MSCI Asian EM by 7.7% in Jun'17.

Debt

FY17 turned out to be a comparatively subdued year for the fixed income market. While the SBP maintained the discount rate at historic low of 5.75% throughout the year, higher oil prices and widening current account deficit meant the market perceived interest rates as having bottomed out. This led to an increase in yields of 10 to 15 basis points in the shorter tenors and 20 to 50 basis points in the longer tenors. As a result, interest remained skewed towards shorter duration instruments particularly in 2HFY17. Investors remained biased towards short term bills as evident by a massive cumulative participation of PKR 687bn in T-bills auctions which was mainly concentrated in 3 and 6 months papers. SBP also conducted the first GOP Ijarah Sukuk auction since February 2016.

Mutual Fund Industry Review

As at June 30, 2017, there were 20 Asset Management Companies managing 233 funds including open end, closed end funds and Voluntary Pension Schemes. The Assets under management increased from PKR 490 billion on June 30, 2016 to PKR 622.35 billion as on June 30, 2017 up 27% over last year with PKR 574.29 billion in Open-end Funds, followed by PKR 22.8 billion in Closed-end Funds and PKR 25.26 billion in Voluntary Pension Schemes.

Due to low interest rates substantial out flow was witnessed in the Income category with majority of it being shifted towards the Equity and Asset Allocation categories during the fiscal year.

The equity fund category (both conventional and Shariah compliant) constituted of PKR 270.69 billion up 37% from last year followed by income fund category (both conventional and Shariah compliant) at PKR 101.46 billion down (20%) and money market category (both conventional and Shariah compliant) at PKR 77.88 billion up 40% from the previous year. This year witnessed an influx of Fund of Funds (both conventional and Shariah compliant) and Asset Allocation Funds (both conventional and Shariah compliant) with net inflows of PKR 37.98 billion in Fund of Funds category (both conventional and Shariah compliant) and PKR 24.38 billion in Asset Allocation Funds category (both conventional and Shariah compliant).

PKR 87.01 billion of total net inflows were seen in the industry during the year with Shariah compliant funds continuing to remain the investors preferred mode of investment as this category received net inflow of PKR 81.96 billion. The Shariah compliant funds AUMs now amount to PKR 237.82 billion vs PKR 157.49 billion last year.

Voluntary Pension Scheme (VPS) registered net inflows of PKR 11.81 billion during the year with the total size of VPS growing to PKR 25.26 billion (PKR 9.11 billion in conventional and PKR 16.14 billion in Shariah compliant category).

Around Fifty One Thousand individual investor accounts were added during the year. In percentage term, the holding of individuals in open-end mutual funds in term of AUMs now stands at 40% versus 34% the last year.

Regulatory Amendments to Promote Growth of the Mutual Funds Industry

1. Change in accounting treatment of element of income

The SECP has issued S.R.O. 354 (1)/2017 dated August 3, 2017, amending the Non-Banking Finance Companies and Notified Entities Regulations, 2008. The amendment includes insertion of a new clause defining the 'Element of Income' as the difference between net asset value on the issuance date and the net asset value at the beginning of relevant accounting period - and a definition of accounting income for the purpose of distribution by mutual funds, which was absent earlier.



Another key change has been made in the Schedule V related to 'disclosure requirements by collective investments schemes' to be filed by the asset management companies in their annual reports to bring it more in line with International Financial Reporting Standards.

In the new format, element of income would no longer be reflected in the profit and loss statement and will now be reflected in unit holders fund.

An additional disclosure will be included in the Income Statement which would bifurcate the Income for the Year as follows:

- ✦ Income already paid to outgoing unit holders on redemption of units
- ✦ Accounting income available for distribution:
 - ✦ Relating to Capital Gains
 - ✦ Excluding Capital Gains

Additionally, "Distribution Statement" has been deleted and its contents merged with "Statement of Unit Holders' Fund".

This notification has removed a major anomaly in accounting of open-end funds, whereby for maintaining "dividend equalization" part of "capital" contributed on incoming units was recognized in the income statement which was against the IFRS guidelines.

MUFAP is in the process of issuing an explanatory circular for standardization of accounting, financial and tax treatment of element of income so that uniform accounting practices for element of income are followed across the industry. The draft is currently awaiting approval from SECP on the same.

A significant consequence from these amendments will be that variable dividends will be issued by the open-end mutual funds i.e. dividend rate will be different for each unit holder depending on the period they were invested in the Fund. The rate of dividend distribution shall vary depending upon the date of purchase of units. This will address the long outstanding issue wherein the capital invested by the unit holder (in the form of element of income) was also taxed at the time of dividend distribution.

For the purpose of disclosure, the fund shall announce the per unit rate based on entitlement of dividend on units that were held for the entire period. Similarly, dividend yield shall be calculated based on opening NAV and dividend payable on units held for the entire period.

2. Incentives to AMCs to increase their outreach through Branch Network

During the year, the SECP has issued a Circular No 40 of 2016 dated December 30, 2016, which allows AMCs intending to increase their outreach beyond the big cities (namely Karachi, Lahore, Islamabad and Rawalpindi) to charge marketing and selling expenses to the open end equity, asset allocation and index mutual funds provided they meet the conditions stipulated in the circular. The conditions stipulate the number of new branches that need to be opened in a year in cities except Karachi, Lahore, Islamabad and Rawalpindi. The selling and marketing expenses can only be used for the following purposes:

- a) Cost pertaining to opening and maintenance of new branches by AMCs in cities except Karachi, Lahore, Islamabad and Rawalpindi.
- b) Payment of salaries to sales teams posted at new branches.
- c) Payment of commission to sales team and distributors in all cities of Pakistan.
- d) Payment of advertising, and publicity of these funds.

Maximum cap of selling and marketing expenses shall be 0.4% per annum of net assets of fund or actual expenses whichever is lower.

The objective of this initiative is to increase the retail penetration of mutual funds and distribution network of AMCs across the country. MUFAP greatly appreciates this step taken by the SECP to promote the expansion of the distribution network and believes it will help the AMCs increase their outreach. MUFAP has requested the SECP to modify this to allow the selling and marketing expenses to be charged to all categories of mutual and to allow branches costs of all branches in all cities as an allowable expense



and not restricted to new branches in cities other than Karachi, Lahore, Islamabad and Rawalpindi. An AMC shouldn't be penalized for opening a branch in Karachi, Lahore, Islamabad and Rawalpindi where still there is largely untapped market segments and potential.

3. Sahulat Sarmayakari Account

The SECP issued Circular No. 33 of 2016 dated November 4, 2016 prescribing simplified criteria for opening of Sahulat Sarmayakari Account for low risk individual customers and branchless banking account customers with total investment limits of Rs. 800,000/- and Rs. 400,000/- respectively. Initially AMC can offer Money Market Fund and/or Income Fund to these customers only and after the completion of the customer risk profiling for assessment suitability of a mutual fund, other categories can be offered.

4. Licensing of Mutual Fund Distributors

The SECP has issued the Securities and Futures Advisers Licensing Regulations 2017 in April 2017. All Distributors selling products of more than one AMC will now be obtaining license from the SECP under these regulations to act as an AMC Distributor.

Requirements for distributors selling mutual funds of a single Asset Management Companies (AMC) have also been prescribed. They would not be required to obtain license from SECP, however would need to meet the qualification and experience and certification requirements outlined in the Circular 41 of 2016. This requirement is likely to provide opportunities to individuals interested to carry out the distribution function of the AMC's and shall also encourage to establish a vibrant distribution network.

5. Standardized Benchmarks for Mutual Funds

All asset management companies were directed to use standardized benchmarks for their collective investment schemes which have been prescribed by the SECP. This measure has been taken to increase investors' awareness and to provide ease of reference to the investors who will now be able to make easier comparison across various mutual funds in the same category.

Public Awareness campaign to facilitate the Retail Investors

For investor awareness purposes, SECP has initiated investor awareness program by publishing pamphlets and brochures on information about mutual funds and voluntary pension schemes for onward dissemination to potential Mutual Funds investors. The same have been shared with AMCs and made available at their branches for investors.

Taxation Anomalies continuing to affect the Mutual Fund Industry

1. Workers Welfare Fund (WWF)

The Finance Act, 2008 had introduced an amendment to the Workers' Welfare Fund Ordinance, 1971 (WWF Ordinance) as a result of which Federal Board of Revenue (FBR) had construed that all Collective Investment Schemes (CISs) / mutual funds whose income exceeded Rs 0.5 million in a tax year were brought within the scope of the WWF Ordinance, thus rendering them liable to pay contribution to WWF at the rate of two percent of their accounting or taxable income, whichever was higher. In light of this, the Mutual Funds Association of Pakistan (MUFAP) filed a constitutional petition in the Honourable Sindh High Court (SHC) challenging the applicability of WWF on CISs which is pending adjudication. Similar cases were disposed of by the Peshawar and the Lahore High Courts in which these amendments were declared unlawful and unconstitutional. However, these decisions were challenged in the Supreme Court of Pakistan.

Subsequently, the Finance Act, 2015 introduced an amendment under which CIS / mutual funds have been excluded from the definition of "industrial establishment" subject to WWF under the WWF Ordinance. Consequently, mutual funds are not subject to this levy after the introduction of this amendment which is applicable from tax year 2016. Accordingly, no further provision in respect of WWF was made with effect from 1 July 2015.



On November 10, 2016 the Supreme Court of Pakistan (SCP) has passed a judgment declaring the amendments made in the Finance Acts 2006 and 2008 pertaining to WWF as illegal citing that WWF was not in the nature of tax and could, therefore, not have been introduced through money bills. Accordingly, the aforesaid amendments have been struck down by the SCP. The Federal Board of Revenue has filed a petition in the SCP against the said judgment, which is pending hearing. While the petitions filed by the CISs on the matter are still pending before the SHC, the Mutual Funds Association of Pakistan (MUFAP) (collectively on behalf of the asset management companies and their CISs) had taken legal and tax opinions on the impact of the SCP judgement on the CISs petition before the SHC. Both legal and tax advisors consulted were of the view that the judgment has removed the very basis on which the demands were raised against the CISs. Therefore, there was no longer any liability against the CISs under the WWF Ordinance and that all cases pending in the SHC or lower appellate forums will now be disposed of in light of the earlier judgement of the SCP.

Furthermore, as a consequence of the 18th amendment to the Constitution of Pakistan, in May 2015 the Sindh Workers' Welfare Fund Act, 2014 (SWWF Act) had been passed by the government of Sindh as a result of which every industrial establishment located in the Province of Sindh, the total income of which in any accounting year is not less than Rs 0.50 million, is required to pay Sindh Workers' Welfare Fund (SWWF) in respect of that year a sum equal to two percent of such income. The matter was taken up by the MUFAP with the Sindh Revenue Board (SRB) collectively on behalf of the asset management companies whereby it was contested that mutual funds should be excluded from the ambit of the SWWF Act as these were not industrial establishments but were pass through investment vehicles and did not employ workers. The SRB held that mutual funds were included in the definition of financial institutions as per the Financial Institution (Recovery of Finances) Ordinance, 2001 and were, hence, required to register and pay SWWF under the SWWF Act. MUFAP responded back that the Financial Institution (Recovery of Finances) Ordinance, 2001 is a special purpose law as the name itself indicates. The purpose for including mutual funds in it was to aid them in being able to recover funds in the case of defaults which was included to safeguard the interest of the unit holders of the mutual funds. It is not a general law to be applied across the industry. For mutual funds, the main law is to be referred to is the Companies Ordinance 1984 (now replaced by Companies Act 2017) which doesn't include mutual funds in the definition of financial institutions. Meanwhile State Bank of Pakistan too, which has included the mutual funds in the definition of financial institution in the Financial Institutions (Recovery of Finance) Ordinance, 2001, that has a limited and specific application has not included unit trusts or mutual funds in the definition of financial institutions in the Prudential Regulations that has broader application across the sector. Thereafter, MUFAP has also taken up the matter with the Sindh Finance Ministry to have CISs / mutual funds excluded from the applicability of SWWF on similar lines as done by the Federal Government.

In the meanwhile, for the sake of prudence, based on legal opinion received, the entire provision against WWF held by the CISs till 30 June 2015, was reversed on 12 January 2017; and the provision in respect of SWWF was made on a prudent basis with effect from the date of enactment of the SWWF Act, 2014 (i.e. starting from 21 May 2015) till such time that the above is resolved.

2. Super Tax Demands

During the previous financial year some funds received notices from the Federal Board of Revenue (FBR) claiming Super Tax on income of those mutual funds. Preamble of Second Schedule provides that "incomes or classes of income, or persons or classes of persons, enumerated in Second Schedule shall be exempt from Tax, subject to conditions and to the extent specified therein". Therefore under Clause 99 of Part 1 to the Second Schedule of the Income Tax Ordinance, income of mutual fund has been exempted from tax. In the definition of tax, Super Tax is also included. MUFAP was of the view, which was also concurred by our tax consultants, that Super Tax proposed to be imposed under section 4B would not be applicable to a Mutual Fund which distributes ninety (90) percent of its income, other than realized and unrealized capital gains, in cash, to qualify for exemption under Clause 99 of Part 1 of Second Schedule to the Ordinance. The matter was contested at the Income Tax Tribunal Level while a stay against recovery has been obtained from the Sindh High Court. During this Financial Year, the Income Tax tribunal has decided the cases in the favour of the mutual funds and has deleted the levy of super tax on the income of the Fund exempted under Clause 99 of Part I of the Second Schedule to the Income Tax Ordinance.



3. Federal Excise Duty (FED)

FED was one of the biggest anomaly for the industry as FED is double taxation and is not tax neutral as the investors in mutual funds are already subject to provincial sales tax on services at 13%. Through the Finance Act 2016 the Government announced that the removal of FED on those services which are subject to provincial sales tax which included asset management services with effect July 1, 2016. Additionally in July 2016, the Honourable Sindh High Court also passed a judgment in our favour in the case that had been filed by the asset management companies, striking down the Federal FED component which was the same as the Provincial law. Federal Board of Revenue (FBR) unfortunately is unwilling to accept this and has challenged the same in the Supreme Court. Therefore although the funds have stopped further provisioning, they will be unable to reverse the provisioning till the Supreme Court's decision in the matter. We are hopeful that the Supreme Court will uphold the Sindh High Court's decision as with the amendments in the Finance Act 2016, the position of asset management companies is even more strengthened.

4. Provincial Sales Tax on Services - Provincial Jurisdictions Issue

The provincial sales tax levied from July 2011 is not tax neutral as this tax is not borne by investors directly investing in securities. As such this tax is against the principle governing taxation of mutual funds. As most of the AMCs and mutual funds are registered in the province of Sindh, and the sales tax is being paid in Sindh. The law governing Sindh Sales Tax enacted by Sindh Revenue Board (SRB) states that sales tax to be provided where business is registered. Meanwhile the Punjab Revenue Authority (PRA) came up with a law that states sales tax to be provided where business is provided. From the financial year 2014, the Punjab Government also started demanding Provincial Sales Tax on the plea that some unit holders are resident in Punjab and demanded a share based on population of the provinces and not on percentage of unit holders. AMCs collectively through MUFAP discussed with both PRA and SRB to resolve the matter amongst them but due to no positive action, AMCs had to obtain stay order from the Honourable Sindh High Court against the tax demanded by the PRA which is still outstanding. However PRA has recently started harrasing asset management companies despite the stay against them. This matter should be settled directly between Punjab and Sindh Governments or the Council of Common Interest should determine the formula for each province instead of sending notices to the AMCs.

5. Imposing withholding tax on Mutual Funds and Approved Pension Fund whose income is exempt

With effect from July 1, 2015, Federal Board of Revenue has required all entities whose income are exempt from income tax to obtain income tax exemption certificates from concerned commissioner of income tax otherwise its tax will be withheld at source and they would thereby need to file refund claims at year end. Collective Investment Schemes, Voluntary Pension Schemes, REIT Schemes, private equity and venture capital funds Modarabas, and all recognized provident, superannuation and gratuity funds have been affected by this move. This move has only created operational difficulties and departmental inefficiencies. The process of grant of exemption certificates is cumbersome and often the applications are rejected without a proper reason or are delayed. There is no tax revenue for the Government as the income of these entities is exempt from tax yet tax is being withheld and refunds not made affecting the investors.

6. Minimum Tax at 8% under section 153(3)(b) of the Income Tax Ordinance 2001

Minimum tax was imposed on the Asset Management Companies, consequent to the omission of the Clause 79 of Part IV of the Second Schedule of the Income Tax Ordinance of 2001 (Ordinance) through Finance Act 2015. The provision of the Section 153(3)(b) of the Ordinance has become effective for companies providing services and 8% tax deductible at source on payment of service under Section 153(1)(b) of the Ordinance has become the minimum tax instead of advance tax. Prior to this amendment the minimum tax for companies providing services including Asset Management Companies (AMCs) was the turnover tax which was 1% under Section 113 of the Ordinance. This substantial increase from 1% to 8% and that too being nonadjustable is adversely impacting majority of the Asset Management Companies and other companies providing services. The Federal Government through Clause 94 of Part IV "exemption from specific provisions" of the Second Schedule Income Tax Ordinance 2001, has granted relaxation of minimum tax at reduced rate 2% instead of 8% for the period beginning on the first day of July, 2015 and ending on the thirtieth day of June, 2018 to the companies engaged in 14 sectors. These Provisions are not discriminatory for the similarly placed companies as some sectors



have been provided relief while others haven't. AMCs with small AUMs, those with losses or new entrants in the industry are adversely impacted through the levy of minimum tax and these AMC's thus suffer Corporate tax at multiples of what their actual tax liability should have been had the normal applicable Corporate tax rates been applied. Also AMC's, by their very nature of business, cannot pass on the additional tax impact to the Funds that they manage. AMCs revenues (primarily management fee for managing mutual funds) are regulated by the SECP and the same is capped. Consequently, AMCs cannot increase their management fees to adjust for minimum tax. Furthermore, an overall expense ratio of the Fund is also capped, as per NBFC Regulations. MUFAP has been pursuing the same since April 2016 to have asset management companies included in the same list without any positive development.

Board Meetings and Attendance

MUFAP Directors have been extremely generous in giving their time and expertise for industry issue. During 2016/2017 tenure of the Board, 18 meetings were held of the Board of Directors. The attendance recorded at the meeting of the Board of Directors for 2016/2017 is summarized below:

No.	Name of Directors	No. of Meetings Attended (18 meetings held)
1	Mr. M. Habib Ur Rahman, Chairman	17
2	Mr. Farid Ahmed Khan, Senior Vice Chairman	11
3	Ms. Maheen Rahman, Vice Chairperson	11
4	Ms. Mashmooma Z. Majeed, Chief Executive	18
5	Mr. Adeel Ahmed Khan	15
6	Dr. Amjad Waheed	13
7	Mr. Shahid Ghaffar	12 (out of 17)
8	Mr. Saqib Saleem	11
9	Mr. Hasnain Raza Nensey**	9 (out of 9)
10	Dr. Ali Akhtar Ali*	5 (out of 8)
11	Mr. Khaldoon Bin Latif	2
12	Mr. Imran Motiwala	1
13	Mr. Imran Hafeez	1
14	On Invitation of the Board: Mr. Yasir Qadri, Chairman Technical Committee	15
* Resigned on February 28, 2017		
** Co-opted on April 7, 2017		

We would like to place on record appreciation for Mr. Shahid Ghaffar for his valuable contributions and endeavors towards MUFAP and the development of Mutual Funds Industry throughout his association with the industry.

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I would like to thank the Chairman MUFAP Mr. M. Habib-ur-Rahman for his continuing support and guidance in strengthening MUFAP. I would like to thank Senior Vice Chairman Mr. Farid Ahmed Khan, Vice Chairperson Ms. Maheen Rahman, Board of Directors and MUFAP Committees' members for their guidance, dedication, teamwork and support. Lastly, my thanks and appreciation for the management team of MUFAP for their continued hard work and commitment.

