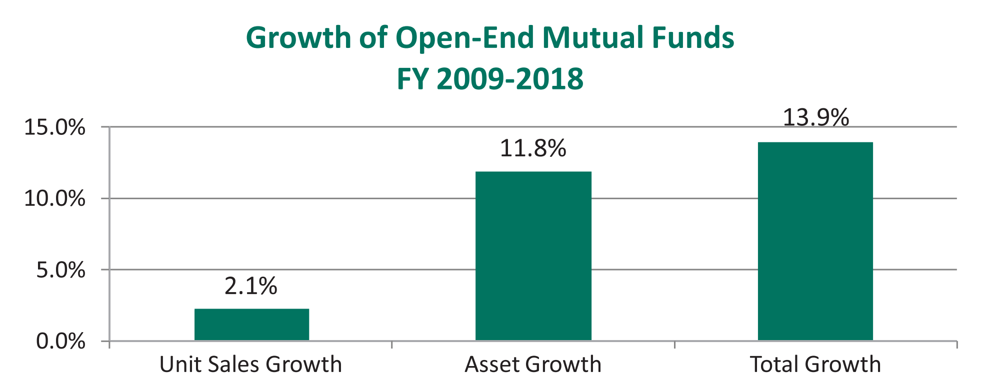
Chairman Review

Mr. Yasir Qadri
Chairman, Mutual Funds Association of Pakistan

Mutual Funds were introduced in Pakistan with the first open-end fund being launched in 1962. However, it was 33 years later in 1995 when the rules were introduced allowing the private sector to launch open-end mutual funds, with the first private sector open end fund being launched in 1997. It wasn't however till the year 2002 when the private sector really started taking the business seriously. Many large brokerage houses and a few banks set up Asset Management Companies. This was followed by a somewhat sporadic growth, with many new companies being set up by 2008. A sharp decline was seen in the year 2008 where the global and local financial crisis nearly halved the assets under management (AUMs), consequently leading to consolidation in the industry and a slow growth upwards. While the growth may appear significant from a low base, it was largely funded by large companies and sponsor banks. However, Shariah Compliant products also grew post 2010. Over the past ten years, the open end AUMs have risen from PKR 153 bn to PKR 564 bn at a CAGR of 13.9% p.a. out of which around 11.8% (PKR 467 bn) is attributable to Asset Growth.



The mutual funds industry currently manages total assets (including Open End, Closed End & VPS) of PKR 610 billion on behalf of over 250 thousand investors in both conventional and Shariah compliant funds. The Industry's role in capital formation of debt and equity, both private and Government, has grown significantly over the years with currently around PKR 294 bn invested in Government Securities & placements with Banks & DFIs, and around PKR 296 bn invested in equities amounting to more than 10% of free float.

Board Review

The Board of MUFAP started its term on October 2, 2017 and over the year undertook the following items:

Regulatory Matters

Change in Accounting Treatment of Element of Income

The Securities and Exchange Commission of Pakistan (SECP) had notified the amendments in NBFC Regulations 2008 pertaining to change in accounting treatment of element of income on August 3, 2017. During the year after being duly verified by Auditors as well as Tax Advisors and with NOC by SECP on the relevant portions pertaining to regulatory amendments, a circular containing the standardized accounting financial and tax treatment of element of income was issued by MUFAP which is being followed by the industry. This change has saved the investors of mutual fund from undesirable administrative hassle, whilst making the taxation more fair and efficient.

Selling & Marketing Expenses

SECP had introduced a circular containing conditions for charging of selling and marketing expenses to Mutual Funds on December 30, 2016. This had been a major achievement and along outstanding representation to the SECP by MUFAP. The circular though a step in the right direction had contained many bottlenecks which were reducing its effectiveness. MUFAP's Board had taken up those issues with SECP extensively throughout the year and it was very encouraging that almost all of our proposals of MUFAP were agreed upon by SECP and a Circular 5 of 2018 was issued allowing selling and marketing expenses to be charged to all categories of funds (except Money Market funds and Fund of Funds) and at all branches in all cities. The industry footprint in terms of branches and fleet-on-street teams has increased meaningfully. However, the industry anxiously awaits the removal of the December 31, 2019 deadline which may halt the process of expanding coverage.

Employees Contributory Funds (Investment in Listed Securities) Regulations, 2018

During the year, SECP introduced the ground breaking Employees Contributory Fund (Investment in Listed Securities) Regulations for which extensive rounds of roundtable meetings were held between SECP, MUFAP and the other stakeholders. While the Regulations are a major step forward for the benefit of members of employee contributory funds and the mutual fund industry, it is also a big positive for the stock market. However, the Regulations may have to be reviewed to remove anomalies which may be counterproductive and defeat the very purpose of developing the regulatory framework.

Major show stoppers as highlighted by MUFAP are:

1. Investment in Debt CIS & Money Market CIS should be 20% of employee fund size and not 20% of investment limit in single AMC.

2. Investment in Equity CIS should be 10% of employee fund size and not 10% of investment limit (which comes to 3% of fund size)

3. Investment limits for Money Market funds should be same as direct investments in Bank Deposits and Government Securities, i.e. upto 100% since underlying investments of Money Market funds are in the same two investment avenues only.

REIT Regulations 2015

MUFAP and REIT Management Companies (RMCs) have been in extensive discussion with SECP over the REIT Regulations 2015. While many other environmental problems persist, a lot of work was carried out to improve the regulatory framework. However, work beyond the scope of the Regulator still needs to be done by the Government. REITS will not only bring a new asset class to public at large, it will also help the Government in making the real estate market more transparent and accessible, not to forget it could be a vehicle for raising funds for real estate development.

The process of launching a REIT is very cumbersome under the existing Regulations. After extensive discussions and meetings, the final draft shared by SECP has addressed majority of the issues and we are hopeful that the amendments once notified will include all the points highlighted to SECP.

KYC and AML Regulations

The Board formed a Committee during the year to work on the standardization of KYC and AML documentation and procedures across the industry. In the interim, new AML Regulations were issued by SECP, so the committee is now reviewing those Regulations for inclusion in standardization of documents under the revised Regulations. The Committee also proposed some amendments in the SECP's Circular 33 of 2016 pertaining to Sahulat Sarmayakari account is on similar lines as of SBP's Asaan Account which is a low risk bank account with simplified KYC procedures. The amendments were taken up with the SECP however the same were not considered. There is a dire need for engagement between stakeholders on this subject. Perhaps the idea of creating a centralized database of customer profile of all financial institutions, banks and non-banks should be seriously reviewed. The idea has been toyed with the non-banking sector only, but that alone will not solve the problem.

Taxation Issues

The taxation matters unfortunately remained unresolved during the year. I greatly commend the efforts made by the Chairman Accounts and Taxation Committee Mr. Razi-ur-Rahman Khan, for the resolution of the taxation issues plaguing the mutual funds industry but lack of understanding and will of the Federal Board of Revenue to resolve the matters remained the biggest hurdle in the resolution of the same.

- Minimum Tax

  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 (AMCs) (11 out of 19 AMCs are affected by this) and other companies providing services including trade associations such as MUFAP. 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, 2019 to the companies engaged in 18 sectors. These Provisions are 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) is 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 reduced rate list without any positive development despite active representations this year to the Senate's Standing Committee for Finance, Mr. Haroon Akhtar Khan and other senior officials at FBR and the Ministry of Finance.

- Requirement for obtaining Exemption certificates under section 159(1) of the Income Tax Ordinance 2001

  Mutual Funds (CIS), Provident Funds, Pension Funds, VPS and some other Entities are exempt from withholding of taxes according to the Income Tax Ordinance, 2001 as their income is exempt from tax. This specifically means tax of CIS cannot be withheld by any party making payment to the CIS. However, FBR issued a clarification on May 12, 2015, according to which it made mandatory for every exempt entity including CIS to apply for exemption certificate under section 159 to claim exemption from withholding. The same was included in our Budget proposals since 2015, however, it wasn't made part of the Finance Act to date.

- 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, 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 and AMCs keep getting notices periodically. This matter should be settled at the Council of Common Interest which should determine the formula for each province instead of sending notices to the AMCs.

Future Outlook

The savings and investments rate in the country is very low at 13% of GDP as compared to the other countries comparable to Pakistan, and mutual funds can play an important role in improving this rate. The industry is perfectly positioned to be a major fund raiser for Federal & Provincial Governments' developmental projects, and meeting government borrowing needs, thus reducing its reliance on borrowing from central bank.

Our Industry has over years felt that the Government has not provided the required attention to the industry and used it for the purpose it was set up as a regulated industry; to channel capital, debt and equity, for government and private sector. The mutual funds industry has not been recognized for its role in the economy as a seamless conduit to asset markets, such as debt and equity, both public and private. There are many examples in the world where mutual fund investing is part of a lifestyle.

The Government and bilateral donors have felt that Government's reliance on the banking system has to reduce. Various measures have been taken reduce the dependence; the stock exchange has been encouraged to list Government paper and facilitate trading by individuals, banks have been pushed to sell Government paper to public, however all in vain. The Money Market and Government Securities Funds are ideally placed for subscribing to the Government paper on behalf of the general public at large. Mutual Funds have earlier also played a significant role by subscribing to the Government Bonds as the government looked to re-profile its debt duration in the earlier part of the decade. The Government should look to utilize the mutual fund industry to reduce its cost of borrowing without having to create another infrastructure. With a little administrative and regulatory support, the mutual fund industry can start reducing the Government's cost in very little time as well as play a significant role in the upcoming developmental and infrastructure projects.

The future of the mutual industry is dependent on increasing awareness across country, efficient means of distribution and innovative product development. The need of the hour is for the industry, the Regulator and the Government at large to work together for collective and public interest. Asset management companies are offering a diversified range of mutual and pension funds to meet the risk appetite of investors, yet the awareness in the masses is lacking of the options available to them. Asset management companies have been conducting awareness & marketing campaigns/ road shows/ seminars individually however the quantum is too low due to limited resources. We have proposed to the SECP to contribute 1 paisa from its annual fee charged to the mutual funds industry and the AMCs will contribute collectively the same amount towards a joint MUFAP - SECP mass scale investor awareness campaign and the execution of such a campaign can be managed by MUFAP.

While the mutual fund industry has evolved considerably from an ease of doing transaction basis, however big piece of opening an account and making that initial investment into a fund, still, largely, is done manually. The sales model lacks a certain degree of scalability with the online feature still not available. We believe that digitization is the key to the future and have recently initiated the process of the inclusion of mutual funds trustees in the NIFT and banking clearing system. This will enable the investors of mutual funds to receive redemption money/payments directly into their accounts maintained with their banks and other facilities.

The growth of mutual funds is also dependent on resolution of taxation issues so unnecessary time and resources are not spend on dealing with these but rather spent productively on the growth and development of the industry. The taxation of mutual funds should be based on three clear principles, as under:

- Mutual funds are pass-through vehicles. Mutual funds itself should not be taxed, but unit holders who hold investment in mutual funds may be subject to tax.
- For investors it should tax neutral if they invest directly in securities or through mutual funds.
- In many jurisdictions tax incentives are allowed to tax payers to promote savings and investments. Such investment should be for promoting long-term savings and not short term of two years.

  While mutual fund unitholders are sahib-e-nisab and are liable to pay Zakat, until they choose to opt out, mutual fund itself should not be liable to Zakat. As mentioned above, Mutual Fund is nothing but a pass through vehicle passing the benefits of investing to its unitholder, hence applying Zakat on the Fund is tantamount of charging double Zakat.

Acknowledgements

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