Challenges and Issues of Indian Mutual Fund Industry: Action plan for Achieving Transformational Growth

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\textbf{ABSTRACT}

The Indian Financial System, in the last two decades, has seen a phenomenal expansion in the geographical coverage and financial spread. The spread of the banking system has been a major factor in promoting financial intermediation in the economy and in the growth of financial savings. With progressive liberalization of economic policies, there has been a rapid growth of capital market, money market and financial services industry including merchant banking, leasing and venture capital. Consistent with this evolution of the financial sector, the mutual fund industry has also come to occupy an important place. The Indian mutual fund industry has grown at an impressive rate in the last few years, the recent developments of the past few months triggered by the global financial crisis have impacted the fortunes of the Industry resulting in AUM decline, adversely impacting the revenue and profitability. Our research has attempted to identify and highlight some of the key issues and challenges being faced by the industry participants that are preventing the industry from harnessing its true growth potential.

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\textbf{Introduction}

During last few years, India’s position as a market having potential for long-term growth has really been noteworthy as the Indian economy is being ranked among the top 10 globally (in terms of GDP), and as the fourth-largest (in terms of purchasing power parity (PPP)). Another good thing to note about Indian mutual funds industry is that it has grown at a rapid pace of 16.4\% during the last 8 years as compared to global growth rate of 13\% during the same period. However, when it comes to assets under management (AUM) of the global mutual fund (MF) industry, India’s ranks is 25th which is not very satisfactory, rather dismal. With assets of around \$76.5 billion (Rs. 3.41 lakh crore) as per AMFI figures at the end of November ’06, India forms just 0.4\% of the world’s global MF AUMs. MF assets worldwide stood at \$19.41 trillion at the end of the second quarter of 2006. US with \$12.4 trillion of MF assets is the topper, followed by Luxembourg (\$1.9 trillion), France (\$1.6 trillion) and Australia (\$723 billion).

Another important criterion which is used by the analysts as parameter to judge the majority of a country’s mutual fund industry is MF assets to GDP (PPP basis) ratio. According to available data, the ratio was 75.2\% for US and 34.9\% for UK. Even in the emerging economies’ list, India’s numbers were far from encouraging. The figure was 23.1\% for Brazil, 26\% for Russia, as compared to 1.3\% for India. There are few other threats which Indian mutual fund is currently facing. The main being lack of investor education which results in risk-return mismatch for investors investing in mutual funds. However, it can be said, in coming years, mutual fund industry is going to take off to newer heights.

In recent years, AMFI has taken several steps to consolidate the Indian MF industry. There are some changes in guidelines that include standardization of the Funds Portfolios and disclosure of the balance sheet of the fund. Among other changes that are scheduled is reduction in the time taken by AMCs to complete formalities from 90 to 42 days. Also proposed is the use of unclaimed money for investor education. The present structure of funds is likely to change from the three-tier framework. This is expected to streamline the operations of the funds and will give them more flexibility. Finally, though mutual funds are primarily composed of stocks, there is a slight difference between these two which makes mutual funds more advantageous to the common investors.

Diversification is the biggest advantage associated with mutual funds. Diversification is the idea of investing money across many different types of investment avenues. When one investment is not doing well, other might be yielding good profit. Diversification reduces risk significantly. In addition to this, by purchasing mutual funds, one is actually hiring a professional manager at an especially inexpensive price. Nowadays, a higher portion of investors’ savings is now invested in market-linked avenues like mutual funds as compared to earlier times.

However, if we compare proportion of people investing in mutual funds in India with that in U.S then we find that in U.S more than 50\% people invest in mutual funds whereas in India the proportion is less than 10\%. This gives the indication that there is much more untapped potential for growth in this industry in India which must be explored in the coming time.

Our research has attempted to identify and highlight some of the issues and challenges being faced by the industry participants that are preventing the industry from harnessing its true growth potential. The following are the key issues of the industry:-
1. Low Levels of Customer Awareness :-

Low customer awareness levels and financial literacy pose the biggest challenge to channelising household savings into mutual funds. Our research results establishes that low awareness levels among retail investors has a direct bearing on the low mutual fund off-take in the retail segment.

The general lack of understanding of mutual fund products amongst Indian investors is pervasive in metros and Tier 2 cities alike and majority of them draw little distinction in their approach to investing in mutual funds and direct stock market investments. A large majority of retail Investors lack an understanding of risk-return, asset allocation and portfolio diversification concepts.

2. Limited Focus on Increasing Retail Penetration:-

The Indian mutual fund industry had limited focus on building retail AUM and has only recently stepped up efforts to augment branch presence in Tier 2 and Tier 3 towns. Players have historically garnered AUM by targeting the institutional segment that comprises 63 percent AUM share.

The mutual fund industry continues to have limited penetration beyond the top 20 cities. Cities beyond Top 20 only comprise approximately 10 percent of the industry AUM as per industry practitioners. The retail population residing in Tier 2 and Tier 3 towns, even if aware and willing, are unable to invest in mutual funds owing to limited access to suitable distribution channels and investor servicing. The distribution network of most mutual fund houses is largely focused on the Top 20 cities given the high cost associated with deeper penetration into Tier 2 and Tier 3 towns. However, some of the mutual fund houses have begun focusing on cities beyond the Top 20 by building their branch presence and strengthening distribution reach through non-branch channels.

3. Limited Flexibility in Fees and Pricing Structures :-

The fee structure in the Indian mutual fund industry enjoys little flexibility unlike developed markets where the level of management fees depend on a variety of factors such as the investment objective of the fund, fund assets, fund performance, the nature and number of services that a fund offers. While the expenses have continuously risen, the management fee levels have remained stagnant. Distributors are compensated for their services through a fixed charge in the form of entry load and additional fees as considered appropriate by the AMC. Regardless of the quality of advice and service provided, the commission payable by the mutual fund customer to the distributors is fixed.

4. Limited Customer Engagement :-

Mutual fund distributors have been facing questions on their competence, degree of engagement with customer and the value provided to the customer. In the absence of a framework to regulate distributors, both the distributors and the mutual fund houses have exhibited limited interest in continuously engaging with customers post closure of sale as the commissions and incentives had been largely in the form of upfront fees from product sales (although trail commissions have also been paid in limited instances regardless of the service rendered). As a result of the limited engagement, there have been rising instances of mis-selling to customers.

5. Limited Focus of the Public Sector Network on Distribution of Mutual Funds :-

Public sector banks with a large captive customer base, significant reach beyond the Top 20 cities in semi-urban and rural areas, and the potential to build the retail investor base, have so far played a very limited role in mutual funds distribution. The India Post network operating the largest postal network in the world majority of which is in rural areas, is stated to have 250 post offices selling mutual funds of five AMCs only; further most of the post offices selling mutual funds are located in Tier 1 and Tier 2 cities which are already been catered to, by national level and other distributors. India Post with its customer base of 170 million account holders and branch network of over 154,000 branches, doubling the size of all bank branches put together is a formidable channel which has been under utilised to date for mutual fund distribution. The postal network also serves as a means to facilitate inclusive and equitable growth to all regions and social groups by providing them with access to financial products such as mutual funds. Further the credibility enjoyed by the Nationalised Banks, Regional Rural Banks and Cooperative Banks in the rural hinterland has not been fully leveraged to target the retail segment.

Research Findings

The endeavour of mutual fund investments is to leverage professional and prudent fund management techniques and thereby maximise returns for the investors while minimising risk. While mutual funds are often the preferred avenue for investment over direct investments into the capital Markets by risk averse investors, customers have had widely varying experiences with purchase of mutual funds. Thus, the research findings help to understand the perspectives of Indian investors so as to use their inputs to further enhance the customer experience with mutual funds.

Methodology:

To understand the opinion of investors in Hubli-Dharwad, we have conducted an purposive sample survey on 300 Investors in December 2011. As part of this survey, we facilitated interviews with a large representative sample of population from diverse backgrounds (education, age, occupation and gender) to understand their preferences and perspective on investment in mutual funds.

A significant portion of customers are aware of and also invest in mutual funds, there was a diverse set of views obtained, both negative and positive. This warrants a need to immediately tackle some of the negative perceptions and capitalise on the positive ones.

Impediments to Mutual Fund Investing:--

Customers believe that the mutual fund industry falls short of expectations in meeting their needs at time of economic uncertainty and market volatility. The research survey has highlighted several reasons that respondents have cited for not buying mutual funds. Some of the prominent challenges highlighted by the respondents have been listed below :-

- Availability of a large number of mutual funds schemes makes investment decision complex and difficult.

The investors witnessed significant rise in New Fund Offers (NFOs) over the last two to three years. As of now there are 979 mutual fund schemes resulting in a total AUM of INR 4,173 billion as on 31 March 2011. The respondents perceive a difficulty in investing in mutual funds in the absence of quality advice. Hence, AMCs need to design simple products that the target segment can easily understand and also realign their product.
**Complicated KYC norms restrict potential investors**

In addition to the PAN card requirement, for an investment amount of INR 50,000 and above in mutual funds, the customers are required to procure KYC acknowledgement. This requires submission of several documents and extensive paper-work. The respondents to the survey expressed difficulty in understanding the complex terminology and the paperwork involved in mutual fund investing. Further, this regulatory directive is viewed negatively by potential customers as investments in insurance products can be undertaken without the requirement for a PAN card. Hence, there is urgent need for the Government to facilitate harmonisation of policies and processes across different verticals in the financial services sector and to simplify documentation that could thereby ease the process of mutual fund investments for retail customers.

**Table No 1: Distribution of study subjects according to reasons for not investing in Mutual Funds.**

<table>
<thead>
<tr>
<th>Reasons for not investing in Mutual Funds</th>
<th>No of respondents</th>
<th>% of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Not a lucrative instrument</td>
<td>49</td>
<td>16.33</td>
</tr>
<tr>
<td>2. No satisfactory returns</td>
<td>30</td>
<td>23.22</td>
</tr>
<tr>
<td>3. No safety of funds invested</td>
<td>7</td>
<td>2.33</td>
</tr>
<tr>
<td>4. Risky investment instrument</td>
<td>18</td>
<td>6.00</td>
</tr>
<tr>
<td>5. No or Less liquidity</td>
<td>0</td>
<td>0.00</td>
</tr>
<tr>
<td>6. No investment knowledge</td>
<td>62</td>
<td>20.66</td>
</tr>
<tr>
<td>7. No knowledge about investment centre</td>
<td>38</td>
<td>12.66</td>
</tr>
<tr>
<td>8. No MF investor education and service centre</td>
<td>6</td>
<td>2.00</td>
</tr>
<tr>
<td>9. It is related to share market so returns are not guaranteed</td>
<td>50</td>
<td>16.66</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>50</strong></td>
<td><strong>16.66</strong></td>
</tr>
</tbody>
</table>

Source: Sample survey results.

**Reasons provided by Survey Respondents for Not Investing in Mutual Funds**

- Insufficient funds for investments
- High Associated Risk
- Complicated product features
- Too many schemes
- Complicated KYC documents being demanded for investments over Rs 50,000
- AMC
- Non availability of service from MF Company
- Non availability of investment support
- Lack of information about fund performance
- Difficulty in monitoring fund performances

**Figure No. 1**

Source: Sample survey results.

- **Banks and IFAs remain the preferred channel given that investors trust them for their advice and after sales service. However, the survey respondents were not satisfied with the quality of advice.**

Banks and IFAs are the preferred channel for investing in mutual funds. Customers expressed confidence in banks given the long standing relationship and the trust built with the banks over the years. Similarly, the customers have become accustomed to dealing with IFAs to seek independent advice on a wide range of investment and financial planning issues. This comfort is expected to play a key role in according priority to the growth of the IFA channel. IFAs have demonstrated flexibility in providing customised offerings to the customers at the household level. It is important to note that an overwhelming majority of the customers have not been satisfied with the quality of advice being provided to them by the advisors. Some customers are of the view that the IFAs are less qualified and do not adopt a holistic approach to financial planning. In some cases, customers have reported instances of mis-selling that has affected the performance of their portfolios significantly. Hence, it is imperative for distributors to re-look at their strategy for financial planning and dispensing advice to customers. After sales service and ongoing follow up have been identified by customers as a key differentiator in assessing the capabilities of distributors.

**Table No. 3: Distribution of study subjects according to methods of tracking performance of Mutual Funds.**

<table>
<thead>
<tr>
<th>Basis for analyzing past performance of Mutual Funds</th>
<th>No of respondents</th>
<th>% of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Past performance</td>
<td>88</td>
<td>71.54</td>
</tr>
<tr>
<td>Ratings</td>
<td>1</td>
<td>0.81</td>
</tr>
<tr>
<td>AMC</td>
<td>15</td>
<td>12.20</td>
</tr>
<tr>
<td>Expert advice</td>
<td>19</td>
<td>15.45</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>123</strong></td>
<td><strong>100.00</strong></td>
</tr>
</tbody>
</table>

Source: Sample survey results.
Drivers for Investment in Mutual Funds:

The factors that can incentivise potential customers to commence and gradually increase their investment in mutual funds were found in the research as below:-

- Investment in Mutual Funds is attractive to customers owing to tax benefits

  The tax benefits associated with investment in mutual funds is the key drivers for customers. Customers consider mutual funds as a medium of ensuring financial independence and security. Since most mutual fund schemes carry easy liquidity options, customers believe that mutual funds are an avenue of savings thereby eliminating the need for borrowing money in case of financial exigencies. Liquidity for the future is deemed to be of utmost importance in making any investment decision.

- Consistency in fund performance and brand equity influence customers to make relevant selection of mutual fund schemes

  Customers believe that fund performance is necessary but is not a sufficient condition to drive their selection of mutual fund products. Selection of mutual funds by a customer is a function of both the fund performance and brand equity of the fund house. Customers are of the view that the key differentiator at the time of selection of a fund is the positive outlook on performance even if the numbers do not reveal a spectacular historic performance. The brand equity of a mutual fund includes factors like perception of the brand capability drawn from its performance in other sectors.

- Simplification of Processes to Increase the Quantum of Investments

  Customers obtain the requisite confidence in their investment process when distributors explain the concepts and the meaning of key terms used in mutual fund application forms in simple terms. Further, this reinforces confidence in the distributor’s capabilities and quality of advice provided that facilitate the decision process for investment in a mutual fund scheme. Customers also expressed the view that a single common application form could be used for all mutual fund investments across multiple mutual fund houses. Simplifying the process for redemption of funds was also identified as a means for further increasing investments in mutual funds.

Table No. 4: Distribution of study subjects according to respondents priorities for investing in Mutual Funds

<table>
<thead>
<tr>
<th>Mean priority of the reasons for investing in Mutual Funds</th>
<th>No of respondents</th>
<th>% Mean Priority</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Good Investment Instrument</td>
<td>1</td>
<td>0.81</td>
</tr>
<tr>
<td>2. Better than directly investing in shares</td>
<td>24</td>
<td>19.5</td>
</tr>
<tr>
<td>3. Assured and consistent return</td>
<td>03</td>
<td>2.43</td>
</tr>
<tr>
<td>4. Provides high return with low risk</td>
<td>28</td>
<td>22.76</td>
</tr>
<tr>
<td>5. Less analysis is required as compared to shares</td>
<td>08</td>
<td>6.50</td>
</tr>
<tr>
<td>6. Very simple to invest and monitor fund performance</td>
<td>08</td>
<td>21.95</td>
</tr>
<tr>
<td>7. Provides cheap access to expensive stocks</td>
<td>08</td>
<td>7.31</td>
</tr>
<tr>
<td>8. Diversification of risk</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>9. Professional management by investment managers</td>
<td>23</td>
<td>18.69</td>
</tr>
<tr>
<td>Total</td>
<td>123</td>
<td>100</td>
</tr>
</tbody>
</table>

Reasons provided by Survey Respondents on Selection of Mutual Funds for Investment Purposes

Figure No. 5

Source: Sample survey results.

Action plan for Achieving Transformational Growth

Research has proved that opportunities exist for surpassing the growth potential of Indian Mutual Fund Industry and making
the industry more profitable through a collaborative efforts across all the key stakeholders to reach out the customer, viz. AMCs, distribution channel partners, service providers, custodians and fund accountants, CII, AMFI, the regulator SEBI and the media, among others. Here are the key initiatives that are required to be undertaken for the Mutual Fund industry to grow and effectively compete in a dynamic environment.

In the event of a quick economic revival and positive reinforcement of growth drivers identified, the Indian mutual fund industry can grow at the rate of 22-25 percent in the period from 2010 to 2015, resulting in AUM of INR 16,000 to 18,000 billion in 2015. Key growth drivers for this should be:
1. There should be increase in retail investor participation with a preference for mutual funds over other asset classes perceived to be more risky. This could result in the fulfilment of growing financial aspirations, enabled by good amount of disposable incomes and increased financial savings.
2. There should be innovations in distribution channels of Mutual Funds driven by increase in the number of certified personal financial advisors and banks selling mutual funds focusing in Tier 2 and Tier 3 towns.
3. The institutional investment in mutual funds should increase triggered by rising corporate revenues with increased economic activity.
4. There should be increase in efforts to draw risk averse customers of traditional products under the fold of mutual funds.
5. The mutual fund companies should attempt to set up their branch presence in smaller towns for tapping the potential.
6. There should be decline in investment management fees by the asset management companies and also flexibility in product pricing by AMCs based on the type of services offered.
7. There should be introduction of mandatory rating for mutual fund products through Rating agencies to increase investor confidence.
8. Efforts should be put to increase the investor awareness and financial literacy, resulting in increase in the contribution of the retail investors to the mutual fund industry.
9. The public sector network of nationalised banks, private banks and post offices should be used as distribution channels of mutual funds.
10. Cooperative sector, though beset with internal administrative issues, can be used as another channel to distribute Mutual Funds.
11. The large network of NGOs, recognised by local authorities should be used to interact and reach out to the lower middle class and poorer segments of population to increase mutual fund penetration.
12. Mutual fund companies have to explore the possibility of innovations such as a common online platform and the usage of debit and credit cards for transactions to facilitate investors for easy payment.
13. The number of AMFI Certified financial advisors should increase so as to focus on initiatives to develop and support the above mentioned channels (for example, recruitment and training support). They can also individually give growth at a faster pace than banks.
14. Mutual fund companies should invest in channel innovation such as Mobile and Internet services. Mobile telephony can enable mobile transactions for the purchase and sale of mutual funds and SMS-based services can revolutionise the industry. The above growth plans can be implemented in the following ways:-

1. Financing a Sustainable Nationwide Customer Awareness Program
   1.1. Creation of the ‘Mutual Fund Education Fund’ – a common corpus of funds from mutual fund companies and distributors through mandatory levy on the investment management fee and commissions earned from mutual fund sales
   1.2. This Fund should be suitably managed/ administered by the AMFI purely for the purpose of Mutual Fund Education.
2. Conducting a Nationwide Customer Awareness Program
   2.1. The Mutual Fund companies should design a comprehensive content for promoting customer awareness programs on mutual funds.
   2.2. The Mutual Fund companies with support from AMFI and other regulatory agencies like SEBI, IRDA, etc., should rollout customer awareness campaigns and provide infrastructure, content and speakers for running the campaigns on a all-India basis over a sustained period.
   2.3. The marketing firms and media companies should be involved to design effective and meaningful mass media campaigns in multiple languages using television, hoardings, flyers, street plays and other mechanisms to reach the masses.
3. Promoting Financial Planning Awareness in Educational Institutions
   The universities in India should encompass modules on mutual funds, and other financial products along with concepts like risk management, asset allocation and portfolio diversification in the syllabus of commerce courses. across all colleges, as a mandatory course from graduation level, followed by an examination. This will lead to mass education on mutual fund concept among the new generation.
4. Introduction of Customer-Friendly Products and Product Features to attract and retain risk averse and first time investors to start investing in mutual funds.
   4.1. The Mutual Fund companies in association with AMFI should conduct a nationwide survey of customer needs across liquidity, risk, frequency and quantum of contribution to determine product variants and features that meet customer needs.
   4.2. The Mutual Fund companies should allow the investible surplus of investors to be invested at any time in ongoing schemes with a flexible SIP option.
   4.3. The Mutual Fund companies should introduce simple products that have features of capital protection with returns that are higher than traditional products and limit market risk.
   4.4. The Mutual Fund companies should focus on the designing of products around women and children related needs, given the growing dominance of women in influencing investment decisions in households across the country.
   4.5. Further commodity related, crop related and agriculture oriented fund products should be conceptualised and developed by cater to segment specific needs.
   4.6. The Mutual Fund companies should focus on product appeal for the low income group by keeping ease of investment and minimum thresholds within affordable limits.
   4.7. The Mutual Fund companies should encourage the introduction of customised Electronic Transfer of funds for retail and institutional customers to facilitate them for easy investment.
5. Price flexibility should be introduced.
   The Mutual Fund companies should do price innovations to focus on distributor compensation and administration so as to encourage them to perform better.
6. Training of the Public Sector Employee Base
Initiatives should be taken by AMFI in Association with RBI to Train employees in the public sector network including India Post, Nationalised Banks, Regional Rural Banks and Cooperative Banks, on sale of mutual funds and basic financial planning.

7. Opening Up of the Public Sector Branch Network in Tier 3 and Tier 4 Towns
7.1. The Mutual Fund companies should commence sale of mutual funds through the branch network of India Post, Nationalised Banks, Regional Rural Banks and Cooperative Banks by focusing on Tier 2 and Tier 3 towns.
7.2. The Mutual Fund companies should boost the presence of Investor Service Centres (ISCs) in Tier 2 and Tier 3 towns and utilise their presence to promote customer awareness of mutual funds.

8. Focus on Increasing Customer Engagement Pre and post Completion of the Investment
8.1. The Mutual Fund companies should focus on growing the financial advisors channel and encourage them to reach out to and engage with customers on their mutual fund needs on an ongoing basis pre and post completion of their investment.
8.2. The Mutual Fund companies should focus on enhancing the marketing and advisory capabilities of all distributors so that they win the trust and confidence of customers.

9. Strengthening of AMFI
9.1. AMFI should play an active role in bringing all the stakeholders together and evolving a strong vision for the mutual fund industry across all dimensions – aspirational AUM growth and profitability, retail penetration, products and pricing, distribution channels, operations and customer service, enabled by a supporting regulatory framework.
9.2. Augment the employee base of AMFI so as to conduct nation-wide customer awareness campaigns.

10. Development of a Common Online Platform
AMFI should coordinate the roll out of a common online platform for all the Mutual Fund companies which will result in increasing reach, reducing distribution costs and making transactions free from operational issues.

11. Acceptance and Rollout of the Unique Identification Card
Implementation of the Unique Identification Card as a valid document for KYC is very much needed. The Government has announced that a Unique Identification Card would be issues to all Citizens (President’s speech at the Joint Session of Parliament on 4th June 2009). This should be implemented and the card should be a valid document for KYC. This will entail undertaking public awareness campaign to make holding of the Unique Identification Card mandatory for all Indian citizens and build the supporting institutional infrastructure to issue these cards at a nominal rate through the public sector network. The Government of India could facilitate issuance of the Unique Identification Card free of cost to all Indian citizens below a specified income threshold which could be in line with the minimum taxation slab limit. This will reduce most of the KYC related problems in Mutual Fund investment process.

Need of the hour:
Given that customer awareness is the pre-requisite for the achievement of the Mutual Fund industry growth potential, there is a need for planning, financing and executing initiatives aimed at increasing financial literacy and enhancing investor education on Mutual Funds across the entire country through a sustained collaborative effort.

Summary:
There is a perceived need to review risk and performance analysis capabilities and governance structures, to meet fiduciary responsibilities and the increasing demand for transparency. The Mutual Fund companies should therefore need to re-orient their business towards fulfilling customer needs. As customers seek trusted advisors, the manufacturer-distributor-customer relationship is expected to be centred not on the sale of products, but for collectively promoting the financial success of customers across all facets of their professional and personal lives. This requires creating a collaborative network of experts in funds management and financial advice, innovative product offerings, efficient service delivery and supporting technology. The mutual fund industry today needs to develop products to fulfil customer needs and help customers understand how its products cater to their needs.

Given that the industry needs to collectively work towards riding over the dynamic and relatively less favourable economic environment at present, the next phase for the industry is likely to be characterised by a stronger focus on customer centricity. Other areas of focus are likely to be cost management and enabling strong governance and regulatory framework – all aimed at helping the industry achieve sustained, profitable growth, going forward.

References