CONSULTATIVE PAPER ON GUIDELINES FOR BANKS' PRIVATE EQUITY/ VENTURE CAPITAL (PE/VC) INVESTMENTS

Background

1.1 MAS announced on 21 Jun 2000 that banks and financial holding companies (FHCs) may undertake only activities permitted by MAS, namely financial activities as well as activities which have clear synergies with the bank's financial business.

1.2 MAS will allow banks to undertake *bona fide* private equity/venture capital (PE/VC) investment as part of the continuum of their financial activities. The nature of PE/VC investing is such that banks may need to hold a major stake in, and be involved in the direction of the investee company. MAS will therefore exempt PE/VC investments from the portfolio equity investment limits[1] announced on 21 Jun 2000, and impose separate guidelines and limits specific to PE/VC business. Within the scope of these guidelines, banks are allowed to acquire or hold shares of any company, which engages in non-financial activities, beyond the equity portfolio investment limits only if it is a *bona fide* PE/VC investment. Banks shall not use these guidelines to circumvent MAS' policy separating financial and non-financial activities. The separation criteria, including the prohibition on sharing of executive directors and management staff, and names and logos, will continue to apply to banks' investments in venture capital businesses. This is to limit reputational and contagion risks to the bank from its investee companies.

1.3 In view of the high risks of PE/VC investments, MAS expects banks to ensure prudent management of these investments. These guidelines are intended to limit a bank's overall exposure to PE/VC investments and requires the bank to actively manage the risks in its investment portfolio. Rather than impose too many

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[1] Each equity portfolio investment is limited to 2% of the capital funds of the bank and must not exceed 10% of the investee company's share capital.

specific restrictions, the guidelines give banks considerable flexibility to manage the risks. MAS will require banks to comply with the proposed guidelines set out below. We welcome any comments on the draft guidelines before 31 Mar 2001.

2 Scope of Guidelines

Bona Fide PE/VC Investments

2.1 PE/VC business refers to the business of investing in companies that show the potential for high growth, and which rewards the high risks that the investor takes on with high returns. The purpose of the investment is to achieve high financial returns, not to control or run the business. The investee companies are usually start-up companies or more established companies embarking on new or turnaround ventures. They could possess proprietary products or services that give them a strong competitive advantage, or they might be entering new industries and markets that offer exceptional investment opportunities. While these investee companies are typically small private companies, they may vary quite significantly in size and stage of growth. In the PE/VC industry, these companies are commonly categorised according to their stage of growth, ranging from seed or start-up stage, to development or expansion stage, and mezzanine stage.

2.2 PE/VC investments span many industries and include both technology-intensive and non-technology-intensive companies. MAS will not limit PE/VC investments to a specified list of approved industries, nor set strict criteria to define which investments are *bona fide* private equity/venture investment. Instead, banks are expected to exercise careful professional judgement when making an assessment as to whether an investment falls within the definition of 'bona fide PE/VC investment'. Banks should be able to produce records of their assessment when called upon to do so by MAS. MAS shall have the right overrule the bank's judgement and decide if an investment should be subject to the PE/VC guidelines or the equity portfolio investment prudential limits.

2.3 While MAS will, in good faith, allow banks to make the assessment as to which investments are bona fide PE/VC, all investments in companies with no track record and unproven technology or business model (but not limited to such) shall be considered bona fide PE/VC investments. These shall include investee companies that have:

i) existed for less than 2 years; and

ii) annual turnover of less than $10m.

2.4 In MAS's view, investments in the following entities do not constitute bona fide PE/VC investments:

i) Listed companies;

ii) Companies whose primary business activity involves providing funds to others, purchasing debt obligations, factoring or leasing equipment;

iii) Companies whose primary business activity is in real estate development or investment; or

iv) Companies engaged in passive or casual businesses, i.e. those not engaged in a regular and continuous business operation.

2.5 Paragraphs 2.3 and 2.4 are not intended to be a set of exhaustive criteria. Banks should assess which of their investments have the characteristics described in paragraph 2.1 when deciding which investments should be classified as bona fide PE/VC investments. Notwithstanding paragraph 2.4, MAS may allow private equity investments in listed companies in restructuring/turnaround situations on a <u>case-by-case</u> basis.

Type of Investment Instruments

2.6 For the purpose of this set of guidelines, PE/VC investment includes all types of ownership instruments including shares, warrants, options[2] and hybrid debt instruments with an element of equity (e.g. convertible loans, loans with warrants).

Debt Securities and Credit Facilities

2.7 Debt securities issued by, and credit facilities[3] granted to, the investee companies will also be subject to this set of guidelines and limits. This is because credit facilities granted to the investee company, whether secured or unsecured, are almost as risky as equity investments, but do not share in the potential upside gains that accrue to equity investors. MAS expects banks to continue to exercise prudence and subject all credit proposals to stringent and independent credit assessment and review process by the banks' loan officers. Banks shall produce evidence of their credit assessments being made on these debt securities and credit facilities, upon demand by MAS.

3 Diversification Policy and Key Appointments

3.1 It is generally accepted that due to the nature and growth stage of the investee companies, a PE/VC business would involve significant risks such as business risk and liquidity risk.[4] MAS expects banks that are involved in PE/VC investments to put in place a comprehensive internal policy for risk management and diversification. The diversification and risk management policy should give due consideration to, inter alia, risk identification; specific investment limits, due diligence

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[2] This includes the value of the equity acquired upon exercise of the warrant or option.

[3] Debt securities and credit facilities of investee companies, as well as the investment vehicle itself (e.g. fund or investment partnership).

[4] Based on feedback from the industry players and analysts, about 40% - 50% of venture capital investments fail completely, with another 30% - 40% only marginally profitable. About 50% of the gains from venture capital investments are derived from approximately 7% of the investments.

process, investment approval process, post-investment monitoring, accounting and valuation method, and exit strategies.

3.2 To limit concentration risk, banks should put in place appropriate exposure limits by industry (e.g., life sciences and healthcare, internet technologies, communications and networking, electronics, software and computer services, etc), stage of investment (e.g., seed, start-up, first stage, second and third stages, mezzanine, etc), geographic region, holding period as well as year of investment.[5] Banks should also set single investment limits and a rigorous approval process for their direct investments in an investee company.

3.3 Feedback from the PE/VC industry indicated that the critical success factor is to have staff with experience and expertise in PE/VC investment as well as sound knowledge of the industries that the investments are being made in. The skill, experience and judgement required of a venture capitalist differ from that of a banker. MAS expects any bank that wishes to actively pursue such a business to ensure that it has a dedicated team of PE/VC professionals with the experience, expertise and skills relevant to the scope of their direct investment activities.

3.4 Banks shall notify MAS of the diversification and risk control measures of their PE/VC business, as well as the qualifications of their appointed key PE/VC professionals.[6] Where banks invest in PE/VC investment partnerships[7] or funds that are managed by third party managers, banks shall also inform MAS of the

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5 Statistics have shown that there is a pattern insofar as investments in some years perform better than investment in other years. This implies that investors should diversify their investments over a number of years.

6 An investment representative's license alone is not a sufficient qualification for a PE/VC professional. Prior relevant work experience, knowledge of specific industries or technologies are more important considerations.

7 An investment partnership is the traditional private equity/venture capital fund structure. It is a closed-end fund and usually organised in the form of a limited partnership or a limited liability company (LLC). Banks may participate in a limited partnership/ LLC as the general partner/managing member, or just as a passive investor.

partnership or fund's diversification policies and the qualifications of the third party managers.

4 Investment Limits

Aggregate Limit

4.1 In recognition of the high risks involved, a bank is not allowed to have aggregate investments whose net book value exceeds 10% of its capital funds. This limit will apply at both the group and the bank level. The aggregate limit includes all direct PE/VC investments undertaken by the bank, its investments in PE/VC investment partnerships and funds of funds,[8] as well as credit extensions to portfolio companies.

5 Duration of Investments

5.1 PE/VC investments should not be held indefinitely as long term investments. They are held for a period of time that gives the investor reasonable opportunity to realise the growth potential of the investee company. The investments are then sold or disposed of and the financial returns disbursed to the investors. To encourage the resale or disposition of investments, investment partnerships typically have a contractual lifetime, the most prevalent term of which is 10 years.

5.2 In line with established industry practice, banks are not allowed to hold each individual direct investment for a period of more than 10 years from the date of first commitment. An investment partnership or fund of funds where the bank is a significant partner/investor with control over the partnership/fund is also subject to the 10-year time limit. Such a partnership or fund should not hold any individual direct investment for more than 10 years from the date of first commitment. Should the bank or such a partnership/fund fail to divest the investment within the stipulated

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[8] A "fund of funds" is essentially a private equity/venture capital fund investing in other private equity/venture capital funds.

time limit, the bank should seek MAS' approval for an extension by providing the latter with a divestiture plan for that particular investment.

5.3 MAS recognises that banks may need or desire to continue to hold their investment even after the investee company has gone public. Banks would be allowed to keep these investments as long as it is still within the 10-year time limit. MAS will allow banks to continue holding stakes in these companies beyond the 10-year time limit only as part of their portfolio investments, which are subject to the equity portfolio investment limits, unless further specific exemption from MAS is obtained.

6 Valuation of Investments and Internal Audit Committee

6.1 As non-listed PE/VC investments do not usually have observable market values, MAS will require the bank to undertake a regular review and assessment of its individual investments by an internal audit committee, which must be independent of the investment officers. Banks shall value their PE/VC investments conservatively and make the necessary provisions for permanent diminution in the value of its investments at the earliest opportunity.

7 Banks' Involvement in Investee Company

7.1 MAS recognises that besides providing the financing, PE/VC business usually requires the investors to play key advisory, strategic and oversight roles in the company. MAS will allow banks to have limited involvement in the investee company to facilitate the bank's monitoring of its financial condition. In line with the policy to separate the financial and non-financial activities in banking groups, bank directors or employees will be allowed to serve only as non-executive directors of the investee company. These staff shall not be involved in the routine operation and management of the company in the normal course of business. Under extraordinary circumstances (e.g., the company suffers from significant operating losses or a loss

of senior management), banks may obtain MAS approval to temporarily manage the company for the time period necessary to address the issues or dispose of the investment.

8 Capital Treatment

8.1 PE/VC investments are highly illiquid and riskier than commercial loans and other portfolio investments, as there is no liquid and deep secondary market for such investments. Furthermore, the potential impact on the financial condition of the bank will increase with its aggregate exposure to such activities. Therefore, MAS requires the bank to deduct 50% of the value of their investments from its capital where its aggregate investment level does not exceed 5% of capital funds. Where aggregate investment level is above 5% of capital funds, MAS will require the bank to fully deduct the value of its PE/VC investments above 5% of capital funds from its capital.

9 Application of Guidelines to Foreign Banks

9.1 These guidelines will apply evenly to foreign banks that conduct PE/VC investments through its Singapore branch except in two respects. First, the capital treatment in paragraph 8 will not apply to foreign bank branches.[9] Second, the 10% aggregate investment limit as a percentage of the foreign bank's net head office funds would apply only to the foreign bank's investments held in the Domestic Banking Unit. Investments held in the foreign bank branch's Asian Currency Unit will not be included within the aggregate investment limit.

10 Organisational Structure and Reporting Requirement

10.1 For clearer reporting lines and separation of the bank's banking business from its PE/VC business, banks are encouraged to set up a separate subsidiary to

[9] Investments of foreign bank branches are subject to their home regulators' capital adequacy rules.

undertake PE/VC businesses actively. This serves to clearly segregate the risks, resources and personnel involved in the PE/VC business. MAS will also allow banks to engage in such a business within their banking operations where they are passive partners/investors in PE/VC investment partnerships or funds of funds, which are managed by independent third-party managers.

10.2 Banks are required to identify and maintain separate records for each of their PE/VC investments for the purpose of internal monitoring and ensuring compliance with this set of guidelines. For MAS' monitoring purposes, banks shall submit the attached schedule of its PE/VC investments on a biannual basis (See Annex A).

Annex A

Schedule of the Bank's Investments in Private Equity/ Venture Capital Activities

Name of Immediate Investing Company	Investee Company	Type / Nature of Business	Year of First Investment	Shareholding of investee capital (%)	Value of investment ($'000)	Value as percentage of capital funds*	
						Bank	Group
ABC Ventures Pte Ltd	XYZ Tech.	Electronics - Chip design and manufacturing	2001	25%	1,000	0.1	0.05
					Total		<10%	<10%

* Please give figures at both bank and group levels.