CONSULTATION PAPER

P009 - 2004
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Capital Treatment for Private Equity and Venture Capital Investments

MAS
Monetary Authority of Singapore

PREFACE

MAS Notice 630 to Banks ("MAS 630"), issued on 18 July 2001, specifies prudential rules for banks' Private Equity and Venture Capital ("PEVC") investments. MAS is proposing to replace the capital treatment for banks' PEVC investments in Section 4 of MAS 630 with the capital treatment described in this consultation paper. Other sections of MAS 630 will remain unchanged.

2 We invite comments from interested parties on the proposed changes in capital treatment for PEVC investments. Kindly submit your comments in writing by 16 Aug 2004. Please note that all submissions received may be made public on a non-attributable basis unless confidentiality is specifically requested for the whole or part of the submission.

3 Please submit your comments to:

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1.0 BACKGROUND

Section 4 of MAS 630 requires Singapore-incorporated banks to deduct from their Total Capital the aggregate amount of PEVC[1] investments according to a graduated scale shown in Table 1 below. The deductions are applied to the portion of the aggregate PEVC investments that fall within the specified percentage range.

Table 1. Current PEVC capital charges under Notice 630

Aggregate PEVC investments (net book value) as a percentage of a bank's capital funds	Deduction from total capital as a percentage of aggregate PEVC investments (net book value) within specified percentage range
The 1st 2%	18%
Next 3%	50%
Next 5%	100%

2 As part of its regular review of existing notices, MAS is proposing a new capital treatment to replace Section 4 of MAS 630. The proposed capital treatment will apply to all PEVC investments held by Singapore-incorporated banks, including existing PEVC investments.

2.0 NEW CAPITAL TREATMENT PROPOSALS

3 MAS recently issued MAS Notice 637 to Banks ("MAS 637") which specifies the "Risk Based Capital Adequacy Requirements for Banks Incorporated in Singapore". The capital framework set out in MAS 637 forms the basis for the proposed capital treatment for a bank's PEVC investments.

[1] Please refer to MAS 630 for the definition of PEVC entities and the type of investment instruments that are covered under the notice.

Accordingly, terminologies used throughout this consultation paper have the same meaning as those set out in MAS 637[2].

4 The proposed capital treatment for PEVC investments recognises that such investments are, on average, of higher risk compared with other asset classes such as commercial loans and equity portfolio investments (i.e., investments of 10% or less in the share capital of the investee company) in established companies, which attract a 100% risk-weight. The proposed capital treatment moves away from the current portfolio-based approach to one that applies capital charges based on the size of the individual investment holdings. This new approach recognises that the capital charge to be applied on a PEVC investment should not be dependent on the size of the bank's aggregate PEVC investment portfolio. Instead, it recognises that large individual investments are more difficult to be disposed of and hence should attract a higher capital charge.

2.1 PROPOSED CAPITAL TREATMENT FOR PEVC INVESTMENTS

5 The following capital treatment for PEVC equity investments[3] is proposed:

(a) Risk-weight at 150% any equity investment of less than 10% in a PEVC entity whether structured as:
  i. a company or a firm; or
  ii. a Collective Investment Scheme[4] ("CIS"); or
  iii. a closed-end fund;

(b) Risk-weight at 150% the first 10% equity investment in a PEVC entity other than a subsidiary[5], and deduct in full from Total Capital the portion of the equity investment in excess of 10% in that entity.

[2] This includes terminologies such as Risk Weight, Deductions from Total Capital, Credit Conversion Factor ("CCF").

[3] "Equity investment" means any beneficial interest in the share capital of a company.

[4] "CIS" and "closed-end funds" are as defined by Section 2 of the Securities and Futures Act.

[5] "Subsidiary" has the same meaning as in Section 5(1) of the Companies Act.

(c) Deduct from Tier 1 Capital goodwill associated with any equity investment in a subsidiary. At the solo level, the balance of the investment should be deducted from Total Capital. At the group level, such PEVC subsidiaries should be consolidated[6] and the applicable risk weights applied to the net tangible assets.

2.2 RISK WEIGHT FOR EQUITY INVESTMENTS IN LISTED PEVC ENTITIES

6 The 150% risk weight proposed in paragraph 5(a) does not distinguish between listed or unlisted equity investments in PEVC entities. Although listed equity investments tend to have more transparent valuations and active trading volumes than unlisted equities, this is not always the case. In fact, liquidation could be equally difficult for both thinly traded listed equity investments and unlisted equity investments.

7 MAS seeks industry views on whether a reasonable distinction could be made between an actively traded listed PEVC equity investment and an illiquid listed PEVC equity investment and if so, what criteria the industry believes could justify[7] a less than 150% risk weight for listed equity investments not exceeding 10% of the beneficial interest in PEVC entities.

2.3 RISK WEIGHT FOR CREDIT FACILITIES EXTENDED TO PEVC ENTITIES

8 Where a bank has equity (or equity-like) investments in a PEVC entity and extends credit facilities to the same entity, MAS proposes to accord a 100% risk weight to the credit facility[8], provided the bank is able to demonstrate that the credit facility:

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6 CIS and closed-end funds will remain as investments on the balance sheet and not be consolidated.

7 Such criteria could include liquidity measures such as the daily volume of shares traded, which indicate the depth and breadth of the market for the particular listed PEVC investment.

8 The credit facility must also rank ahead of equity in respect of the repayment of principal and interest in a winding up situation (senior loan).

(a) does not contain any equity-like features; and

(b) is extended on an arms-length basis and subject to the same credit assessment and approval process as any other corporate loan.

Otherwise, the credit facility will be treated as an equity-like facility and aggregated with the equity investment in the PEVC entity for computation of capital requirements using the methodology in paragraph 5 above.

9 In relation to paragraph 8(a) above, the following credit facilities are deemed to contain equity-like features and shall not be accorded a 100% risk weight:

(a) Instruments with non-cumulative dividends or coupons;
(b) Irredeemable and perpetual instruments;
(c) Instruments that constitute lending of a capital nature;
(d) Subordinated debt, convertible debt and debt with warrants or ‘equity kickers’ where the option to convert is mandatory or is at the option of the issuer, and not the bank;
(e) Equity-linked instruments; and
(f) Collective investment schemes that are not treated as securitisation.

2.4 CREDIT CONVERSION FACTOR (“CCF”) FOR UNDRAWN COMMITMENTS EXTENDED TO PEVC ENTITIES

10 MAS proposes to apply a 100% CCF to undrawn commitments extended to PEVC entities, regardless of their original maturity. This recognises the relatively certain drawdown of these commitments extended to PEVC entities. Commitments that are unconditionally cancellable at any time without prior notice may be accorded a 0% CCF, as is the case under MAS 637.

2.5 CONDITIONS FOR EXCEEDING AGGREGATE INVESTMENT LIMIT /MAXIMUM HOLDING PERIOD

11 MAS 630 currently prohibits a bank's aggregate PEVC investments to exceed 10% of the bank's capital funds and stipulates a maximum holding period of 10 years for direct investments in PEVC entities, and 15 years for PEVC investments made through independent funds. However, in exceptional circumstances where a bank is unable to liquidate an investment within the holding period because of poor market conditions, MAS may consider allowing an extension of the holding period. Similarly, in exceptional circumstances where the bank exceeds the aggregate investment limit (e.g., sudden reduction in capital funds due to losses), MAS may consider approving a temporary limit increase. These practices will remain unchanged.

12 However, where an extension of the holding period is granted, MAS may impose conditions to ensure that these PEVC investments are bona fide financial investments, rather than investments held for long-term control purposes[9].

13 In the case where a bank obtains MAS' approval to exceed the aggregate investment limit, MAS proposes to deduct the aggregate net book value of PEVC investments that exceed 10% of capital funds from Total Capital.

[9] Examples of conditions that MAS may impose include deducting the residual net book value of PEVC investments that exceed the maximum holding period from Total Capital or imposing supervisory capital under Section 10(3) of the Banking Act.

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