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27 January, 2015

Dear Sirs/Madam,

IVCA Representation to Expert Panel: Investment by Pension Funds in Alternative Investment Funds: Private Equity and Venture Capital

Introduction

The Indian Private Equity & Venture Capital Association (IVCA) welcomes the establishment of an expert panel to review investment guidelines of pension funds in India.

PFRDA has allowed Pension Fund Managers (PFMs) to invest upto 40% of the total AUM in rated, investment-grade corporate debt securities with a minimum residual maturity 3 years, subject to an exposure limit of 10% of total AUM in non-sponsor group companies. PFRDA has further allowed PFMs to invest in rated Infrastructure Debt Funds and Asset-Backed Securitisation transactions under this category.

Our Association believes and recommends that it is best practice for pension funds to allocate a certain percentage of their investments in Alternative Investment Funds (AIFs) including private equity and venture capital investments with adequate safeguards.

This letter briefly sets out the rationale for this recommendation as well as highlights the experience of selected countries.

Rationale for recommendation to enable allocation to AIFs by Pension Funds as part of investment guidelines of pension funds in India

The rationale for allocation to AIFs is based on the following factors:

1. Long-term and close-ended nature of Category 1 and Category 2 AIFs makes it a suitable asset class for pension funds and annuity products of insurance companies as permitted by IRDA

2. India has a growing pool of experienced AIF managers with commitments of over Rs.17,000 Crores
3. Development benefits for the Indian economy
4. Asset-allocation to AIFs can be prudently managed as they are active investors
5. Overseas pension funds are already investing in India so it is helpful to consider their expertise and experience of other countries in this regard.

Each of these factors has been described in more detail below.

A. Long-term nature of Category 1 and Category 2 AIFs makes it a suitable asset class for pension funds and insurance companies

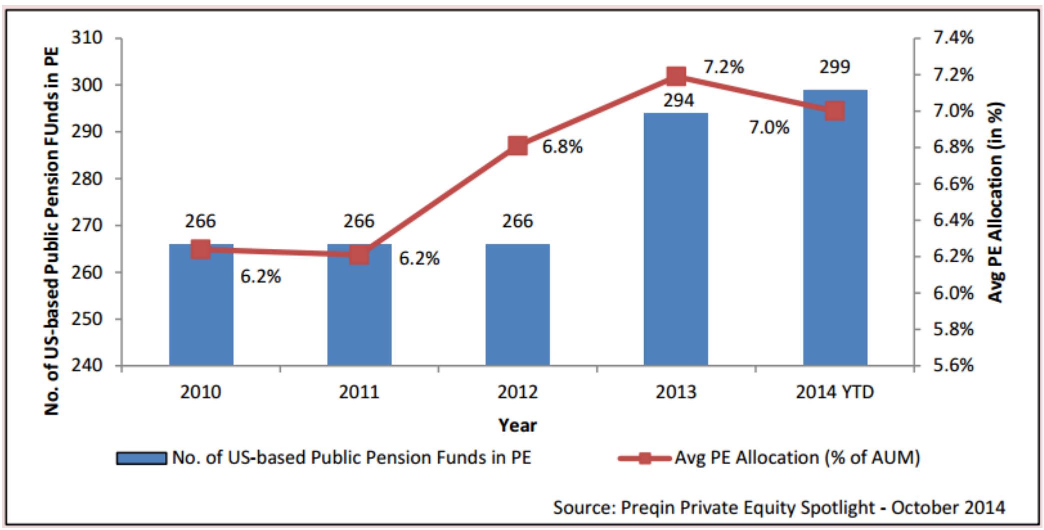
Pension funds form one of the largest categories of investors in the venture capital and private equity asset class. It has been so traditionally because of the long term nature of these asset classes and the liabilities of pension funds. Pension funds have long term liabilities with limited need for liquidity as a percentage of total asset size, and funds have 8-10 year fund cycle, thereby making it a good match for both of them. Public and private pension funds made up 43 percent of capital invested by PE funds during 2001-2011.4 On a dollar-weighted basis, the U.S. public pension funds invest 10.3 percent of their portfolio in private equity. European public and private pensions allocate around 4 percent to the asset class whereas Australasian allocations are just over 5 percent. Given the large asset under management of the pension funds, the absolute value of their investment in PE asset class turns out to be significant. Table A below gives the target investment in PE asset class for some of the largest pension funds around the world.

Table A

Fund	Assets under management ($, billion)	Target investment in PE as a percent of assets under management
Stichting Pensioenfonds ABP, The Netherlands	427	5%[@]
California Public Employees' Retirement System (CalPERS), USA	289.8	13%[#]
California State Teachers' Retirement System (CalSTRS), USA	189.1	12.8%[&]
Caisse de dépôt et placement du Québec (CDPQ), Canada	176	10%[*]

Figure B below shows the total number of US-based public pension funds that have invested in PE and their average allocation to PE asset class over the past four years. It can be seen that in recent years there has been growth both in the number of funds that invest in PE and also in the allocation to the PE asset class.

Figure B



Another source of long-term funds is life insurance companies. In India insurance companies have been permitted to invest in AIFs by IRDA.

In August 2011, IRDA brought out a clarification with respect to the types of investments specified in the 2008 circular. Accordingly, it was indicated that insurers can invest in any venture fund registered under SEBI Regulations which included venture funds investing in micro, small and medium enterprises as well. It was also clarified that no investments shall be made in a venture fund which was under the promoter group of the insurer and the investment manager should also not be directly or indirectly controlled or managed by the insurer or its promoters. The exposure norms specified in the 2008 circular remained unchanged.

Pursuant to a change in the nomenclature of venture fund regulations under SEBI in May 2012 (SEBI Venture Capital Funds Regulations 1996 was replaced with SEBI (Alternative Investment Funds) Regulations 2012), IRDA brought out a circular in March 2013 granting permission to insurers to invest in Category I Alternative Investment Funds (AIFs).

Accordingly, insurers were allowed to invest in Category I AIFs which invest in start-up or early stage ventures or social ventures or SMEs or infrastructure or other sectors which the Government or regulators consider as socially or economically desirable. This included venture capital funds, SME funds, social venture funds and infrastructure funds. Such funds were not permitted to invest in companies incorporated outside India. The other regulations stayed the same as in the previous circular.

Lastly, in August 2013, IRDA notified that insurance companies can invest in Category II AIFs also. So the permitted funds in Category I are infrastructure funds, SME funds, venture capital funds and social venture funds, while in Category II at least 51% of the funds of such AIF was required to be invested in either infrastructure entities, SME entities, venture capital undertakings or social venture entities. All the other restrictions regarding investment of funds outside India and promoter group holdings remained unchanged. Thus the last set of regulations released in August 2013 has expanded the scope of investments, in addition to giving a continued focus on the infrastructure and SME sectors.

SEBI places no restriction on the type of investors, whether domestic or overseas, that can invest in AIF schemes. Various other financial sector regulators have also allowed institutional investors to invest in Category I AIFs as follows:

Type of Entity	Regulator	Single AIF Exposure limit	Aggregate AIF Exposure Limit
Banks	RBI	None prescribed by RBI; left to the discretion of each Banks' Boards	Aggregate Capital Market exposures capped at 40% of Networth Investment in shares, convertible bonds/ debentures, units of equity-oriented mutual funds and all exposures to Venture Capital Funds (VCFs) capped at 20% of net worth
NBFCs	RBI	15% of net owned funds as per Prudential credit concentration norms	None

Type of Entity	Regulator	Single AIF Exposure limit	Aggregate AIF Exposure Limit
Insurance Companies	IRDA	10% of Fund size	3% of Investment Assets in case of life insurers and 5% of Investment Assets in case of non-life insurers
National Pension System	PFRDA	Not allowed	Not allowed
Employee Provident Fund	EPFO	Not allowed	Not allowed
Other Provident Funds	Ministry of Finance	Not allowed	Not allowed

Besides, the Finance Ministry has amended the investment guidelines of Non-Government Provident Funds, Superannuation Funds and Gratuity Funds to allow investments in rated Infrastructure Debt Funds and Asset-Backed Securitisation instruments with a minimum maturity of 3 years with effect from April 1, 2015. The Finance Ministry has also allowed these Funds to invest in Debt Mutual Funds regulated by SEBI from April 1, 2015.

B. India has a Growing pool of Experienced Fund Managers

Private equity and venture capital began to grow in India around the year 2000. Nearly a decade -and –a- half later, private equity and venture capital fund managers have now gained significant experience. Foreign pension funds have invested in several local fund managers. These managers have internal processes to conduct due diligence, require the right conditions precedent, select good management teams and require pre-investment approvals of internal investment committees. Pension funds can invest in such funds after satisfying themselves of the capabilities of the available pool of fund managers and conducting thorough due diligence.

We believe that Alternative Investment Funds carry risks which are similar to other rated instruments like corporate bonds, schemes of Mutual Funds, Infrastructure Debt Funds and Asset Backed Securitisation papers, subject to the minimum acceptable rating threshold. SEBI has allowed different investment vehicles according to the suitability of such vehicles to different categories of investors viz., Mutual Funds meant for public at large more specifically for retail investors, Infrastructure Debt Funds for long gestation projects and Alternative Investment Funds for informed and institutional investors. Nonetheless, the underlying theme of all these vehicles is similar.

Also, regulations provide for better diversification of risks given that the exposure to each portfolio entity is capped at 25% of the AUM and co-investment requirements prescribed by SEBI for sponsor / investment manager ensures the Investment Manager's commitment to the performance of the fund throughout the tenure.

C. AIFs generate Developmental Benefits

While the primary role of any asset class, including private equity and venture capital, is to provide a suitable rate of return to its beneficiaries, its developmental role cannot be ignored. Category 1 AIFs focus on asset classes like private equity, venture capital, infrastructure, SMEs etc. thus providing growth capital which helps create jobs and supports industrial and commercial innovation. Long term investments by private equity and venture capital funds are well aligned with the aims of economic development . The funds are run commercially and do not compromise the need for providing sustainable returns to pension fund investors apart from ensuring proper due diligence in safeguarding the investments of the investors.

D. Pension funds can prudently invest in AIFs as they are active investors

Once the regulatory permission is granted for investing in AIFs, Pension Funds should establish prudent investment criteria and procedures for selecting the funds offered by AIF fund managers.

Pension funds should also consider focusing their attention on operational due diligence. At a minimum, this means pension funds should have an understanding of "key-man risk" and performing background checks on the funds' portfolio managers, analysts and business leaders. It is also essential to test the firm's trading capabilities, reviewing its compliance procedures and understanding the valuation policies in place. Beyond kicking the tires in the asset manager's operation, pension funds must also look externally to vet the fund's service providers, to determine their stability, independence and procedural discipline. Pension funds must understand that any service interruption, failed technology, employee turnover or compliance violation could be just as serious, if not more so, than a failed investment idea.

For pension funds without significant internal resources, Fund –of- Funds may offer a turnkey solution, providing investment due diligence, operational due diligence and a well-diversified portfolio. While investing directly may sound like a less expensive way to get alternative exposure, the true price of direct investing goes beyond management fees. Direct investing demands an extensive governance process and robust infrastructure, including risk management and reporting systems, not to mention the price tag of the time and effort of manager evaluation.

In establishing terms and conditions for investing in private equity and venture capital funds, pension funds can consider the principles set by the Institutional Limited Partners Association (ILPA), which is playing a significant role in improving transparency. With over 250 members, many of whom are pension funds, collectively managing over $1 trillion in private assets globally, ILPA has established operating guidelines to drive consistency in the manner in which GPs are reporting certain information to their investors. Its Private Equity Principles center around an alignment of interests, improved governance and increased transparency.

AIFs as an investor class are active investors as when an investment is made, a partnership is formed and the AIFs is motivated to work with a company's management team to create value.

AIFs also share business know-how and help build companies' businesses before exiting by launching initial public offerings or selling their stakes to other fund investors. Using various tools such as operational improvements, corporate governance enhancements or environmentally friendly policies, private equity, when done well, has the potential not only to generate significant returns – its hands- on nature also helps build better businesses, leading to numerous knock-on effects including job creation, a broader tax base and sustained economic growth – and it is committed to doing so over several years.

E. Overseas Pension Funds are already investing in India

Renowned international pension funds from several countries are already investing in India. Pension funds in India can take a cue from them and learn from them as they develop their strategies to invest in Indian private equity and venture capital.

Country Experiences

(a) US Experience

US pension funds were allowed to invest in private equity for the first time in 1978 as a result of reforms to the US Employment Retirement Income Security Act (ERISA) guidelines. Under the 'prudent man rule', pension fund managers were given discretion to make a variety of investments in addition to bonds and public equities, so long as these investments did not endanger an entire portfolio. At the time, pension investments in private equity totaled US$64 million; by September 2013, private equity investment from the top 200 US pension funds had reached over US$300 billion.6 With the introduction of these new and significantly sized pools of capital, the domestic private equity and venture capital industry, as measured by the number of funds and fund managers, exploded.

(b) South Africa

South Africa is playing a leading role in this regard, with the promulgation of a revised Regulation 28 of the Pensions Fund Act in 2011. This revision allows retirement funds to invest up to 10 per cent of Assets Under management (AUM) in private equity, up from a historical figure of 5 per cent for all alternative asset classes. A pension fund may invest up to 2.5 per cent of the total fair value of its assets in any one private equity fund and up to 5 per cent in any one fund of private equity funds. This is subject to the proviso that a pension fund must not invest more than 10 per cent of the total fair value of its assets in aggregate across private equity funds or funds of private equity funds. This limitation is also subject to the further limitation that a pension fund may not invest more than 15 per cent of its assets across both hedge funds and private equity funds.

(c) Thailand

An international fund-of-funds manager Capital Dynamics has been mandated to advise the Government Pension Fund of Thailand (GPF) on its private equity program. The GPF in 2009 had no exposure to private equity outside its home nation despite having assets in excess of US$10bn. The fund has allocated 3% of its assets to international private equity, which it aims to build-up during 2010-2013 under the advice of Capital Dynamics.

(d) Turkey

A combined limit of 20 percent applies for both retail and private investment funds. There is a 4% limit for each individual fund. The fund should be registered with the Capital Markets Board.

According to the Wall Street Journal, The fund, Ordu Yardimlasma Kurumu, known as Oyak, is Turkey's largest nonstate-run pension plan. Created in 1961 to provide Turkish army officers and Ministry of Defense staff with supplementary retirement benefits in addition to the basic state pension they receive as civil servants, its members pay in a compulsory 10% of their salary, drawn out on retirement, along with the returns earned.

Oyak, which oversees the savings of more than 230,000 serving and retired military personnel, has Euro 1.9 billion ($3 billion) to spend on purchases and investments in Europe this year. Oyak functions more as a private-equity fund than a traditional pension provider.

"We are a conglomerate and a pension fund," said Caner the fund's chief investment officer. "There were no capital markets in Turkey when we were founded, so we started investing directly in companies. We have more than 60 holdings now."

Oyak's diverse domestic equity holdings include subsidiaries in the cement-and-concrete sector, an automotive-manufacturing and distribution joint venture with French car maker Renault SA, and a 49% stakeholding in the Iskenderun Enerji power plant, located on the west side of Iskenderun Bay in Turkey.

Oyak also owns 49% of Eregli Demir ve Celik Fabrikalari, or Erdemir, the largest flat-steel producer in Turkey. It purchased the stake from the state's privatization administration in a $2.96 billion cash transaction, which was partially financed through borrowing in the international markets.

While it may be difficult to emulate the example of Oyak, similar strategies can be employed by pension funds by investing in AIFs.

IVCA is available to provide any information on AIFs, private equity and venture capital fund investing to the expert committee.

Thank you,

Kind regards,

Arvind Mathur

President

IVCA

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