Funds Hotline

August 29, 2013

STIMULUS FOR ONSHORE FUNDS: INSURERS ALLOWED ENHANCED INVESTMENT COVERAGE

Insurance Regulatory and Development Authority ("**IRDA**"), the regulator for insurance and re-insurance business in India, recently released a Circular[1] concerning investments in Alternative Investment Funds ("**AIF**") registered with Securities and Exchange Board of India ("**SEBI**") under the Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**").

The Circular allows insurers to invest in an increased gamut of onshore funds. The move is welcome as it helps in deepening the capital pool that onshore funds in India can access. The present capital pool for India focused funds is predominantly contributed by foreign funds and domestic HNIs. However, given the global liquidity crunch and fight for capital, understandably, a need was felt for a deeper domestic pool consisting of institutional investors.

IRDA'S PROPOSAL

The AIF Regulations regulate all forms of vehicles set up in India for pooling of funds from investors, Indian or foreign, on a private placement basis. The AIF Regulations have defined several categories of funds with the intent to distinguish the investment criteria and relevant regulatory concessions that may be allowed to them.

Category I AIFs encompass AIFs with a defined investment strategy focusing on Venture Capital Funds, Small and Medium Enterprises Funds, Social Venture Funds and Infrastructure Funds, which in SEBI's view, lead to "... positive spillover effects on the economy". Category II AIFs encompass AIFs that may not need any focused incentives. These would include private equity funds and debt funds. Category III AIFs could be used to set up an onshore hedge fund structure with prescribed levels of leverage.

Subject to exposure limits, the Circular allows insurers to invest in Category I AIFs and those Category II AIFs that have a mandate to invest at least 51% of their investible corpus in entities that are venture capital undertakings, small and medium enterprises, or which are engaged in social venture or infrastructure sectors. The Circular restricts insurers from investing in funds which use leverage or that are fund of funds.

The Circular revises the earlier position whereby insurers could invest only in such Category I AIFs that were engaged in infrastructure sectors or invested in medium, small and micro enterprises (MSME) related opportunities.

EXPOSURE LIMITS

The Circular provides the following exposure limits within which insurers can invest:

Type of insurer	'Overall Exposure' limits to Venture Capital Funds (VCFs) and eligible Alternative Investment Funds (AIFs)	Exposure limits
(a)	**(b)**	**(c)**
Life Insurance Company	3% of the Fund value	Lower of: (i) 10% ('20%' in case of Infrastructure Fund) of the corpus of the eligible AIF / VCF, or (ii) 20% of Overall Exposure as per column (b).
General Insurance Company	5% of Investment Assets. 'Investment Assets' mean investments made out of shareholders' funds representing solvency margin and policyholders funds at their carrying value as shown in its balance sheet drawn as per the IRDA (Preparation of Financial Statements and Auditors' Report of Insurance Companies) Regulations, 2000, but excluding items under the head 'Miscellaneous Expenditure'[2]	

ANALYSIS

The recent move to allow insurers to expand coverage of onshore funds is in line with global standards where insurance companies tend to actively participate in private equity. As providers of patient capital, insurers are a valued class of investors for funds.

The Circular is a welcome development. However, given the tough fundraising environment, the regulators may consider allowing other categories of investors to participate in onshore funds including SEBI registered Foreign Venture Capital Investors (FVCIs), to participate in onshore funds.[3]Another category of investor that could be considered is pension funds. Such funds are globally regarded as among the largest contributors of capital to private equity funds.[4] Even a fractional allocation by India based pension funds could translate to substantial increase in the capital pool.

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Sovereign wealth funds ("**SWF**") should also be looked at as a potential investor class for onshore fund. Allowing participation by SWFs would further widen access to capital.[5] The recently released report of the Committee on Rationalization of Investment Routes and Monitoring of Foreign Portfolio Investments recognizes government and government-related entities such as SWFs, to be classified as Category I (low risk) foreign portfolio investors.

Similarly, the regulators could also consider allowing participation by SEBI registered foreign institutional investors (FIIs) into Category III AIFs given the possible similarities in investment strategies and risk profile.

- Adhitya Srinivasan & Richie Sancheti
You can direct your queries or comments to the authors

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[1] Circular No. IRDA/F&I/INV/CIR/172/08/2013

[2] Circular No. IRDA/F&I/CIR/INV/067/04/2013

[3] Circular No. CIR/IMD/DF/10/2013 seems to recognize FVCIs as a distinct source of foreign investor for Category I, Category II and Category III AIFs which do not undertake leverage. However, amendments to relevant provisions of Foreign Exchange Management (Transfer or Issue of Security by a Person resident outside India) Regulations, 2000 (TISPRO) and Foreign Direct Investment Policy would be required for clarity.

[4] These include pension funds such as *Ontario Teachers' Pension Plan and the California Public Employees' Retirement Scheme* (CalPERS).

[5] SWFs cumulatively manage assets in excess of USD 5.8 trillion. Sovereign Wealth Fund Institute (updated August 2013) Available at http://www.swfinstitute.org/fund-rankings/

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