5 January 2018

On behalf of the Public Affairs Executive (PAE) of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

Response to EIOPA's Consultation Paper on its second set of advice to the European Commission on specific items in the Solvency II Delegated Regulation

I. General Comment

The private equity industry welcomes the opportunity to respond to *EIOPA's second set of advice to the European Commission on specific items in the Solvency II Delegated Regulation*, in particular on the treatment of "unlisted equity".

Our industry appreciates the Commission's and EIOPA's efforts to explore the possibility of introducing a specific standard formula treatment for investments that support jobs and growth and ensure that they are appropriately treated in insurers' prudential requirements.

We continue to believe, however, that the 39% risk charge which is currently foreseen for certain private equity and venture capital funds included in type 1 equities is still too high and does not properly reflect the real risk investors face when investing in the asset class. In addition, the 49% risk charge applied to those private equity and venture capital funds that do not meet the definition of those funds that would potentially be included in type 1 equities also does not properly reflect the real risk faced by investors in those funds. Moreover, we believe that the current risk charges may very well be acting as a barrier to insurance firms investing in private equity.

We have previously presented data supporting our contention that a 39% risk weighting is inappropriately high for private equity[1] and we do not believe that any substantive argument has been made against either the logic or validity of the technical analysis presented in these papers.

[1] Invest Europe research papers: "Calibration of Risk and Correlation in Private Equity Based on LPX 50 NAV Index", May 2012 and "Calibration of Risk and Correlation in Private Equity", October 2013

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We believe that it is appropriate and legitimate for a sub-category to be created to allow for a more appropriate risk calibration of private equity investments (where “private equity” is used to refer to all segments of the unquoted investment industry, including venture capital). This sub-category should be based on common characteristics of private equity or venture capital funds and should not be dependent on where these fund are managed, nor under what regulatory regime the fund or its manager operate.

In our opinion the rationale for creating such a sub-category would not be dissimilar to that reflected in the creation of qualifying infrastructure investments under Solvency II: namely, that there is a combination of types of investments, methods and processes by which an insurer invests in those investments, that result in a lower risk approach to gaining exposure to unlisted companies, than is implied by the current treatment of private equity under Solvency II.

We encourage EIOPA to consider such an approach and we of course stand ready to provide any further information on this subject to assist in ensuring that EIOPA’s final advice provides appropriate criteria to allow private equity to be appropriately treated under the Solvency II framework.

II. Introduction

We interpret the term “unlisted equity” used in the draft advice (Section 11 of EIOPA document), to be a generic term used to define an insurer’s exposure to companies that are not listed on a public stock market. We do not interpret it in a narrow way to simply mean the holding of shares (also referred to as “equities”) in unlisted companies. We believe this to be an important distinction and not a matter of semantics.

In the Commission’s request to EIOPA for technical advice on the review of specific items in the Solvency II delegated regulation as regards unjustified constraints to financing, the Commission explicitly mentions *”removing barriers to investments in unlisted equity, in order to improve insurers’ ability to invest in private placement offerings and in private equity”*.

In setting a sound regulatory framework for risk calibration, it is critical that the approach taken reflects the way in which exposure is achieved by insurers. The reality is that insurers primarily gain exposure to private equity through diversified portfolios of closed-end, 10-year life funds.

The insurance firm’s commitments to these funds are drawn down by each fund over a number of years (not all invested on day one). The insurance firm realizes its return from the private equity fund only as and when the underlying investments are realized and the proceeds returned to the investors in the fund.

The manager of an insurance firm’s private equity exposure is, therefore, primarily responsible for constructing and managing a portfolio of unlisted funds, not a portfolio of equities in unlisted companies. The risks to be managed by the manager of the insurance firm’s private equity portfolio are those associated with the risks of fund manager selection, portfolio construction and cash flow management in respect of the ability to meet draw downs of commitments made to the funds as they are due. The fact that these funds invest in companies that are unlisted categorically does not mean that the insurance firm has a pro rata holding in the underlying unquoted company. The management of the underlying companies in which the private equity funds invest is wholly the responsibility of the manager of the private equity fund, not the insurance firm that has invested in the fund.

It should also be borne in mind that insurance firms make their first decision about managing the risk of investing in private equity at the point at which they first decide whether or not to have any exposure to the asset class at all. The risk of being able to bear any loss of capital invested is the critical risk considered at this point. If the considered decision is that there is capacity to bear this risk, the next risk management decision the insurance firm makes is what level of exposure to have to the asset class. Finally, the insurance firm will decide how it will implement its asset allocation decision: a portfolio of private equity funds managed by an in-house team of experts; an outsourced solution of appointing a fund of funds manager to manage the fund portfolio; or, some combination of the two. Very occasionally an insurance firm may choose to invest a small portion of its private equity allocation directly in the shares (or “equities”) of a few unlisted companies, alongside the funds in which they invest, in a co-investment arrangement.

Our comments set out below in this response are based on this very important distinction between investing in the shares (or “equities”) of unlisted companies and investing in “unlisted equity”, in the sense of investing in private equity, primarily through a diversified portfolio of funds. This is because we believe strongly that this distinction impacts the validity and practicality of the methodology of the risk calibration approach chosen.

III. Detailed comments

Section 11.1

We note that EIOPA has been asked to provide advice on criteria for investments from the EEA that could benefit from the same risk factor as listed equity. We do not believe, however, that this should mean that the criteria could not, nor should not, also be applied to the same types of investments in geographic locations outside the EEA.

When an insurer decides to invest in private equity, the decision is taken in respect of the asset class as a whole. Unlike listed equity investing, which can neatly be categorized into specific geographic locations based on inclusion of a company's shares on a particular listed stock market, asset allocation decision-making in respect of private equity investing is not geographically led. The more global, or at least multi-geographical, nature of the investment vehicles in this asset class (i.e. private equity funds) means that asset allocation decisions are taken in respect of the asset class as a whole.

By creating an artificial regulatory distinction between the risk profile of private equity funds from within the EEA and those from outside the EEA has no logic from the perspective of an insurer's assessment and management of risk. In addition, it runs the practical risk that, faced with an excessively and artificially high risk charge for one part of its private equity exposure, the insurer can make the very rational decision to stop investing in the asset class completely.

Consequently, any artificial differentiation in the risk charge across private equity funds that an insurer would deem to be its universe of potential investments, could well result in a significant increase in the barriers to investment in private equity within the EEA. Insurers' ability to finance the development of companies in the EEA would be reduced.

Section 11.3

Scope

Paragraph 764 - 765

We agree with other stakeholders that the scope of the call for advice is too narrow and that it ought to be expanded to help find a more realistic and pragmatic approach to risk calibration for insurers in private equity. To that end we would welcome EIOPA's detailed rationale for rejecting the alternative methods for deriving a risk charge for the asset class explained. At the moment we do not have sufficient clarity as to why alternatives have been rejected and so it is difficult to help work towards a better solution.

Risk relevant factors

Paragraphs 772 and 773

We agree with the view that due diligence is important and that the existing provisions under Solvency II are sufficient. We would, however, regard the level of transparency and disclosure about companies in which private equity funds invest to be no more important than is the case for investors in pooled vehicles of listed equity investments. When investing in pooled vehicles that invest in listed equities, the investor is required to be carry out due diligence on the manager of the pooled vehicle, rather than on the underlying companies in which the pooled vehicle invests.

Suggested approaches

Paragraph 776

Our members' experience suggests that private equity carries similar underlying risks (with the exception of liquidity risks) as public equity with a small-mid cap bias, and therefore its risk weighting should, at least, be in line with public equity. Liquidity risk is managed separately at both fund manager and insurance company levels. To penalize private equity investments relative to public equity investments in a way that small cap public equity investing is not penalized relative to large cap public equity investing would seem irrational. Furthermore, it would harm private companies' ability to seek sources to support their growth and development (financial and human capital) and so harm the real economy. The risk calibration for private equity could therefore also consider this factor, in line with what is currently applied to infrastructure investments. In this regard we agree with the proposal of other stakeholders to extend type 1 equity classification to all unlisted companies in OECD countries <u>as a bare minimum step forward</u>.

<u>Section 11.4.2</u>

Scope & general approach to identity qualifying unlisted equities

Paragraph 781

We note that the Commission's call for advice restricts the scope to equity investments in companies. We would contend, however, that the scope of the call for advice is in respect of unlisted equity investment and not restricted to investment in companies. This has an important bearing on the development of any approach taken to determine the risk calibration of an insurer's investment in private equity.

Paragraphs 782 - 786

We believe that the possible approaches being considered by EIOPA are aimed specifically at investment directly in the equities/shares of unlisted companies and are not appropriate for the more typical form of investment by insurers in private equity, namely investment in unlisted funds, or funds of funds.

We do not find the approaches to be appropriate for investment in funds, or funds of funds because although these funds invest in the equities/shares of unlisted companies, this does not translate into the investor in the fund having any legal pro rata share of the ownership of the equities of the companies in which the fund invests. We believe the approaches suggested by EIOPA are based on an incorrect expectation/assumption that the funds themselves are irrelevant in the investment and risk management of an insurer's exposure to private equity. The approaches appear to assume that the only, or at the very least the most important, risk, by a very large margin, for the insurer investing in private equity funds is reflected in the financial metrics of the underlying companies in which the funds invest. This is incorrect and ignores the real risks that any prudent insurer investing in private equity funds must manage. Investors in private equity funds should manage the risk at a fund level.

The insurer's investment is its share of the legal entity which is the fund, not the underlying companies. The funds themselves are the investments that the insurer makes. The portfolio of investments the insurer manages is its portfolio of funds. Consequently, in building its private equity exposure the insurer has to consider and manage the risk characteristics associated with the funds themselves and how the insurer builds and manages its portfolio of funds, taking into consideration the nature and characteristics of the fund entity itself. For example:

a) what are the skills of the manager of the fund?;
b) is the manager executing the investment strategy it indicated it would?;

c) is the manager of the fund acting in accordance with the terms of the fund's governing document?;
d) how does the manager of the portfolio of private equity funds ensure that the risk profile of the portfolio fits within the overall objectives and risk profile for the total assets of the insurer?;
e) how does the manager of the fund portfolio ensure that he is properly managing the cash flow risks associated with managing a portfolio of investments in which the flow of cash between it, the investor, and the different funds within the portfolio is properly managed to ensure that its obligations to meet draw downs of the insurer's commitments are able to be paid as they fall due?.

In our opinion there is a further reason why the approaches being considered are inappropriate for insurers that invest in private equity funds, or funds of funds. The approaches would take a snapshot of the underlying investments of the funds at a fixed point in time. In listed equity investing this may be perfectly appropriate. Most listed companies are generally well-established entities aiming to make steady progress along a clear path albeit with incremental developments along the way. In contrast, one of the fundamental purposes of private equity investment is to invest new financial capital and human resources to bring about a fundamental transition of a business over a period of a number of years. Taking a snapshot of the financial metrics of a listed company and an unlisted company that is in the hands of private equity ownership and going through a period of transformation and making the assumption that one is comparing like with like is potentially completely misleading. For example, flat profits for the listed firm may be a sign of a set back, but for an unlisted firm in the midst of a major transformation of its business it may be a sign that it is fulfilling plans ahead of schedule and so be a very positive indicator. This means that without context, financial metrics of a company can be a potentially misleading tool.

In addition, when an unlisted company is going through a period of transition it is explicitly not intended that the owners of the equities/shares in the company are seeking to trade their shares during that period. Investors in the equities/shares of listed companies are invariable constantly looking to see whether they should sell, buy or continue to hold these equities. Consequently, whether the company is listed or unlisted is relevant for how an investor reacts to a particular set of financial metrics at any point in time.

Finally, we would note that where investors invest in pooled vehicles of listed equities regulation would treat the pooled vehicle as the investor's investment, not the underlying assets in which the pooled vehicle has invested. There seems no rationale for treating investment in pooled vehicles that invest in unlisted equities any different.

Paragraph 788 and 789

We would strongly urge EIOPA to carry out further work and to reconsider its position on alternative approaches based on an acknowledgement that the primary risk faced by insurers investing in private equity (which is the primary route for insurers' investment to reach unlisted companies) is associated with the percentage of total assets allocated by the insurer to private equity and the method by which that allocation is then invested and managed. Insurance firms would like to see a risk calibration methodology that is appropriate for the risks they take. In this way their risks would be properly acknowledged and assessed and we believe unlisted SMEs would be able to receive the investment of financial and human capital from private equity to enable them to grow and develop and become the listed companies of tomorrow.

Look-through approach: Introduction

Paragraph 790

Risk is multifaceted and we believe it is a significant oversimplification to state that taking a company private, or listing a company does not alter "the risk". It completely depends on what aspect of risk is considered and risk to whom. Moreover, insurance firms invest primarily in private equity funds, not in unlisted companies. It would seem much more appropriate to reflect this in the approach taken to risk calibration.

Beta method

Notwithstanding our main contention that it is inappropriate to base an approach on the assumption that investing in private equity funds is fundamentally no different to investing directly in the shares of unlisted companies we see various flaws in the beta method proposed in the EIOPA draft advice.

Observations on methodology:

1. Because of the need to have to artificially create beta for unlisted equities, the approach would seem to automatically exclude the investments of any funds that invested in the venture capital stage of private equity investing, or in that portion of a buyout fund that were invested in companies in the financial sector. This does not seem rationale from the point of view of an insurer investing in a diversified portfolio of funds.

2. It looks as though the analysis to create beta is based on running simulations of portfolios containing 2, 10, 20 and 50 companies. Paragraph 811 of the EIOPA document states that *"each equity investment should not represent more than 10% of the total value of the unlisted equity portfolio"*. As there is abundant evidence that when investing in a diversified portfolio of funds, an insurer derives indirect exposure to several hundred companies, this approach would seem to be a lot of effort to arrive at the same conclusion that if the insurer is invested in a well-diversified portfolio of funds, it ought to be treated as type 1 risk charge.

3. On the general point that beta is a proxy for systematic risk, we question the relevancy of this as it should surely be the aim to measure the risk of the investment, not the risk that the investment price crashes when the market crashes. A very risky asset with a low beta would pass the test and a low risk asset highly correlated with the market would presumably not. Additionally, a beta approach based on correlation is questionable given that correlations tend to change significantly during a major crisis.

4. Moreover, we do not understand the basis for the choice of 0.85 as the cut-off value and we would welcome further clarification on this point.

5. We would also query the mathematical logic behind a regression based on company statistic factors to compute beta. We are not convinced that table 2 demonstrates that the method is working as well as suggested. For a portfolio with a beta just below 0.85, there is a 40% probability that the investor would be wrongly classified.

6. On a pragmatic level, we believe that data to support the analysis required for the beta method will not (or will only partially) be available. It would, therefore, make it extremely difficult if not impossible to implement in most cases.

That is because most of the factors that are required to calculate the beta need five years of historical data. Private companies are typically held for 3-7 years. At the time the investment in the company is made by the private equity fund, the data may very well not be available to the manager of the private equity fund. This can arise because the investment is in a relatively young company that has not existed for five years, or the investment involves a major restructuring of a business, or is a business created to effect a consolidation of several previously unconnected businesses. Furthermore, although investors in private equity funds frequently receive quite detailed financial information about the underlying companies in which the funds invest, they are not shareholders in these companies and so have no rights to demand access to confidential information from those companies. This situation is doubly so in the case of exposure through fund of funds, where the insurer's investment is in the fund of funds itself, not the underlying funds and not the underlying companies in which those funds, in turn, invest.

Combine this with the companies that would be excluded on the grounds that they are in the financial sector and it could start to add up to a significant portion of the insurer's investments that would effectively be excluded simply on the grounds that the method cannot deal with the investment.

Paragraph 815

Whilst we accept that beta may be well established in academia and the financial industry in relation to public equity investing, we disagree that beta is well established in the private equity industry. Beta is not used in the private equity industry because Net Asset Value is not a definitive measure, but merely an indicative one. It is an interim indication of the expected value that will be realized in the future.

Stressed period loss method

Notwithstanding our main contention that it is inappropriate to base an approach on the assumption that investing in private equity funds is fundamentally no different to investing directly in the shares of unlisted companies we also see some flaws in the stressed period loss method proposed. The method, as defined, is also not straightforward and we would be interested to learn whether or not it has been back tested and if so what those results show.

Paragraph 819

The draft advice suggests that the stressed period loss method has similarities to methods for measuring the performance of private equity relative to listed equities, the so called "Public Market Equivalents" (PME). We do not believe, however, that the approach proposed does have much in common with measuring performance under the PME method.

Paragraphs 821 - 831

The description of the method identifies the financial risk of the loss of investment that shareholders face if they are invested in a company that has debt and the company is unable to service this debt (due to insufficient cash flow to meet its obligations) and the company becomes insolvent, thus placing the equity holders in a position of only having a residual claim on the assets of the company. In stating that this financial risk cannot be diversified away, we believe this is ignoring two aspects of investing in private equity funds that gives greater risk management control to investors.

The first is that there is much greater active management of the investment by the manager of a private equity fund (in comparison to the manager of a listed equity portfolio), including the likelihood that the private equity fund manager will have been able to appoint a director(s) to the board and may well have taken on those directorship roles directly. This makes it much more likely that, before a company defaults on a loan, the manager of a private equity fund is able to intervene and help avert the potential default. There is also ample evidence to show that the rates of default by private-equity backed companies is measurably lower than in listed companies.

A study by the Bank for International Settlements (2008), looking at leveraged buyouts globally between 1997 and 2001, showed that there is significant evidence that the average default rate for private equity portfolio companies is effectively lower than the average default rate for non-private equity-backed borrowers. In Europe, the default rate is up to 25% lower than for non-private equity backed companies) (Kaplan and Strömberg (2009)). Moreover, those private equity-backed companies which do default spend less time in financial distress and are more likely to survive as an independent, reorganised company than non-private equity backed companies. In addition, the study also suggests that the failure rate for private equity-backed companies is at least 5% lower than similar publicly owned companies. Several other studies have also found that private equity-backed companies generally have better corporate recovery and survival rates (Frontier Economics Report, Exploring the impact of private equity on economic growth in Europe, May 2013). Looking at the impact of the financial crisis in 2008/9 a study by Jason Thomas of the PEC in the US (The Credit Performance of Private Equity-Backed Companies in the "Great Recession" of 2008-2009, March 2010) analysed a data set of 3,200 private equity-backed companies acquired between 2000 and 2009 and held through 2008-09. The results showed that private equity-backed companies defaulted at a rate of less than 50% of the rate for non-private equity backed companies: 2.8% v 6.2%.

While this does not alter the consequences of default should it happen, it is relevant for assessing the impact of default risk (or financial risk as defined in the paper) on an insurer's overall assets when investing in private equity.

Moreover, consideration of default risk is front and centre of an insurance firm's decision-making on investing in private equity from the outset. It informs the decision as to whether or not to invest in the asset class in the first place and if so, what percentage of total assets is prudent to allocate to it. The management of default risk is then one of the key considerations on how to gain exposure to the asset class (directly in unlisted companies, investment in a portfolio of funds or fund of funds). If exposure is gained through investment in a portfolio of funds, then portfolio construction is informed by consideration of default risk in terms of the number and type of funds invested in and amount committed to each fund, etc.

Paragraphs 845 - 846

We believe there are flaws in the sector classifications and sector allocation limits. It is unclear how companies in private equity funds will be assigned to the sector categories identified in paragraph 840. There are (large) parts of the private equity and venture capital industry where there is no obvious listed equity industry sector equivalent for companies. Moreover, the 5% cut-off within a single industry subsector seems unnecessarily restrictive. Insurers look at private equity fund investment as a single asset class and look to diversify by the categories and classifications that they attach to funds (stage of investment, vintage year, etc). The insurance firm's investment universe and fund selection decisions are not defined by the characteristics and sector categorizations of the underlying companies in which those funds may invest. We also believe that as industry sector risk is not a defining parameter for public equity classification, it should not be a defining parameter for private equity either.

Paragraph 847

It seems to us that none of the proposed areas of further work would address the issues of concern we have highlighted in this response.

Requirements on the investment vehicle in the look-through approach

Paragraphs 854 – 857 (Underlying investments)

In respect of private equity investing this requirement seems unrealistic and again makes the false assumption that an insurer has a pro rata ownership of the underlying companies in which the private equity fund invests. It would also exclude most venture fund investments and investments by later stage funds in companies undergoing major transformation and restructuring. It again creates an artificial regulatory classification of risk. Finally, it is effectively imposing an arbitrary asset allocation to the asset class which has no bearing on any individual insurer's circumstances or ability to bear risk.

Paragraph 863 (Diversification)

In our opinion defining diversification as having spread funds across *"at least 25 independent fund managers"* has no evidential justification and appears to be a completely arbitrary number.

This statement also appears to misunderstand that to have 25 fund managers in a private equity portfolio is likely to result in the insurer needing to have at least 50 funds in the portfolio. It is very likely that if the fund manager is deemed to be high quality, the nature of investing in 10 year closed-end funds means that there are likely to be at least two funds managed by a single fund manager active and in the portfolio of the insurer at any point in time. There is potential that this approach would force insurers to over diversify their portfolios and in so doing potentially force them to lower their fund selection criteria. This we think would not be right from a prudential point of view. There is also ample existing evidence on the impact of diversification on risk reduction in private equity fund investing, such as Diller and Jaeckel: Risk in Private Equity, October 2015.

Paragraph 864 – 866 (Transparency)

When an insurer is investing in private equity funds, we believe that they are best placed to know what information is necessary to be able to conduct proper due diligence to arrive at an investment decision on a particular fund. Given that investment in a fund is made before any investments are made by the fund, it is clearly not possible to have information on underlying investments that have not yet been made. Obtaining access to financial data, such as profit and loss, cash flows and profits (whatever definition of this is appropriate on the circumstances) for investments made previously by the fund manager may have a place in the due diligence process. It is not, however, by some considerable measure, the defining data required in deciding on whether or not to invest in a private equity fund. We therefore believe that reference to these criteria is not appropriate.

Paragraphs 868 and 870 (Own risk management)

It may seem a matter of semantics, but the insurer should surely be able to demonstrate the ability to perform proper due diligence and expertise in investing in private equity funds, not unlisted equities, if that is its chosen route to investing in private equity. Indeed, insurers will invariably invest in funds because they deem that they do not have the necessary skills to invest in unlisted equities themselves. Moreover, if they select a fund of funds manager, they ought to be able to demonstrate that they have taken due care in selecting and retaining that manager, just as they ought to do when appointing the manager of a listed equity portfolio.

When investing in private equity funds there are always "cash calls" to be managed because of the nature of fund structures whereby the commitment made to a private equity fund is drawn down gradually, usually over the first 5 years or more of the life of the fund. Managing the risks associated with cash flow management is one of the key risks that insurers manage when investing in private equity funds and creating a portfolio of funds.

Paragraphs 873 – 875 (ESG factors)

While we believe the consideration of environmental, social and governance (ESG) criteria is an increasingly important element in many investors' due diligence process and in principle we welcome the idea that the management of ESG issues are important enough to be considered as part of the thinking about how to approach risk calibration, we also think that it is a difficult concept to factor in to a risk calibration methodology. Firstly, there are currently too many possible standards and criteria to pick a definitive list/standard to which all must adhere. Secondly, even the Principles for Responsible Investment[2] are just "principles" and not definable, measurable criteria. As a general point, we believe it should be clear whether the insurer has an ESG policy and if so how it is implemented in respect of its assets allocated to private equity.

[2] https://www.unpri.org/

What we see in practice in our industry is that ESG risks and opportunities are increasingly being integrated into the whole investment process by private equity fund managers, from pre-acquisition due diligence on a company, though the period of active management in which ESG performance improvement programmes are developed and implemented within companies in which the funds invest. Reporting of how value has been enhanced and protected through ESG issue management is increasingly being included in the due diligence material offered to potential investors by private equity fund managers. However, it is not generally correct to say that "funds are being managed according to ESG criteria".

Of the two approaches put forward in paragraph 875, therefore, (approaches that we have interpreted as being in respect of the manager of a private equity fund, rather than the insurance firm investing in private equity funds) our preference would be for the first option, namely to require fund managers to declare that they conform to certain ESG standards. In practical terms we would see this as meaning that the manager of a private equity fund was required to be transparent with its investors as to what **its** policy on ESG is and how it implements and monitors it. Getting ESG criteria to become an integral part of the mindset of investing is important and more effective than fund managers seeing ESG as something separate from their investment process. So by putting the onus on the fund manager to articulate its approach to ESG from the outset (during due diligence) and include reporting on its implementation through the life of a fund to its investors would be an effective way of integrating consideration of ESG in private equity fund investing.

It is also important to bear in mind that there is a diverse range of ESG factors and potential criteria and also that the nature of investing in unquoted companies often means that exposure to ESG factors is in a state of flux. For example, where there is a buy and build strategy being pursued by a private equity-backed business it is quite likely that at the time of an acquisition, the company being acquired may not meet the ESG criteria of the fund manager. But it is inherent in the decision to make the acquisition that these issues are to be addressed and in so doing it contributes to making a better, more sustainable business overall. This should be seen as a fundamentally positive thing to do and no regulation ought to deter business from making such acquisitions simply on the grounds that the investment at the time of the acquisition does not yet meet the ESG criteria.

The second approach being suggested that would involve an external assessment seems both impractical (by whom and on what basis/criteria) and of limited value to insurance firms.

The incorporation of consideration for ESG issues in the approach taken to investment (in all sectors) is important and to be encouraged and we have set out here how this can be (and indeed increasingly is being) incorporated in the private equity sector. At this stage, however, it is unclear how and indeed if the risk calibration methodology for private equity in Solvency II regulation should be the route to further encourage this process. In the context of insurers' risk management of private equity investment, consideration of it is one of many qualitative factors taken into account as part of their due diligence process. When investing in private equity, due diligence is a combination of qualitative and quantitative factors and the evaluation of ESG factors is currently more to the qualitative end of the spectrum for most insurance firms. It also potentially questionable why private equity should be treated so differently in respect of ESG than other asset classes. For example, the management of ESG factors ought to be as relevant in the risk management of listed equity investment.

Specificities of private equity

Paragraph 877

While a better governance structure in private equity does have a positive impact on risk management in private equity, the more pertinent point is the impact of the active management of the investment by the manager of the private equity fund.

One of the specific characteristics of private equity is that it brings human capital to a business to help it develop and grow, not just the investors' financial capital. In practical terms that means private equity fund managers not just being represented on the board of the company (either directly or indirectly) but also taking an active role alongside the company's management team on specific operational projects to help develop the business or being involved closely on matters of financial governance and oversight, particularly in relation to the company's ability to service its debt obligations. Moreover, the private equity fund manager is in a position, working with the management team, to take action in a very timely manner to address and head off any potential breaches of covenants before they occur. That is a very clear example of how private equity results in a better risk profile within the 12-month period relevant for Solvency II.

Paragraph 878

In this paragraph EIOPA concludes that the listed companies used to calibrate the type 1 risk charge are "more diversified in terms of business lines and geographies than typical companies in which PE funds invest". It is unclear to us, however, how EIOPA can substantiate this conclusion and we would welcome further details in that respect.

EIOPA correctly states that marginal risk reduction decreases with the number of investments and notes that the diversification benefit from adding another company to an existing portfolio of 100 companies is much lower than adding one to a portfolio of 20. As a private equity fund will typically invest in around 15 – 20 companies we are struggling to understand the basis for requiring diversification across at least 25 fund managers (which in practice will mean around 50 funds, so over 700 companies) under the diversification requirements in paragraph 863.

Paragraph 879

It is a fact that, by definition, there are no market prices to determine the "value" of an unlisted private equity fund that invests in unlisted companies. In an attempt to try and address this situation within the context of Solvency II, we have previously put forward suggestions as to how this could be done based on the nearest proxy our industry has for "price", namely Net Asset Value. It was by no means intended as a perfect solution, rather it was an attempt to offer a less imperfect solution than one based on LPX 50.

We are also unclear what EIOPA meant by its conclusion that *"it does not seem warranted to give PE credit for the fact that the investment is illiquid and that market prices are not available"*.

We continue to believe strongly that the risk in private equity that should be evaluated is not market price related but more based on the real risks that insurers in private equity face and seek to manage, namely the risk of not getting back the capital invested (or the unrealized interim value of capital invested) at the end of the life of the fund in which they have invested.

Contact

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About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About Invest Europe

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members' role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

For more information please visit www.investeurope.eu.