Submission

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

11 July 2013

To **European Commission - DG MARKT**

Capital and companies - Unit H2 – Banks and Financial conglomerates II

Re **Response to Consultation by the Commission on the Structural Reform of the Banking Sector**

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The European Private Equity and Venture Capital Association (EVCA) is a member-based, non-profit trade association that was established in 1983 in Brussels. EVCA is a member of the Transparency register (ID: 60975211600-74).

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Executive Summary

We write on behalf of the representative national and supranational European private equity and venture capital ("PE/VC") bodies. Our members cover the whole investment spectrum: from the institutional investors investing in a broad range of PE/VC funds to the PE/VC firms raising such funds to invest in the full life-cycle of unlisted companies, from high-growth technology start-ups, to the largest global companies.

The Public Affairs Executive (PAE) of the European Private Equity and Venture Capital industry welcomes the debate launched by the European Commission in its consultation on the Structural Reform of the Banking Sector, and the opportunity to provide comments and relevant data.

The private equity (including venture capital) (PE/VC)[1] industry plays an important role in delivering smart, sustainable and inclusive growth that creates jobs and enhances the European Union's competitiveness for the long-term. This role partly hinges on the relationship of the PE/VC industry with the banks. The EVCA is therefore closely following the developments in the discussions regarding the reform of the banking sector.

The industry supports the objectives pursued by the Commission: establishing a stable and efficient banking system at the service of the EU real economy, increasing economic growth, reducing instability and improving resource allocation, all while enhancing the internal market.

The debate on the structure of banking is an essential component in a wider discussion about banking reform; but it must not happen in isolation from those debates already under way on the capital requirements for credit institutions, the mechanisms for recovery and resolution, and the improvements to the supervisory structure. Ultimately, any decision on the structure of banks should duly take into account other reforms and the ways in which they modify the legislative and regulatory landscape.

As representative of the whole investment spectrum, including institutional investors, the PAE is concerned with the scope of the reform, the way the separation would be implemented and its impact on the PE/VC industry. Our primary concern is that the private equity industry retains the ability to finance SMEs and contribute to the European economy.

The industry is particularly concerned that in their consultation paper, the European Commission services do not treat banks' relationships with private equity appropriately. The requirement to separate exposure to private equity and to assign it to the trading entity within a bank has not been justified in the analysis presented in the consultation paper. It risks preventing our industry from delivering the benefits that the private equity model can bring.

We consider that the Commission's approach is not justifiable given the nature and scale of the risks that a bank would be "exposed" to through its relationship with private equity, and does not take into account the comprehensive overhaul that has taken place in the European financial regulatory framework and which now ensures an adequate regulation of risks, from the perspective of both banks and funds. The lack of clarity and coherence on the nature of exposures that are separated will impact the consultation process and arguably make it more difficult for respondents

[1] The term "private equity" is used in this paper to refer to all segments of the industry, including venture capital. The term "venture capital" is used in specific contexts where there are issues that relate particularly to this segment.

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to submit relevant and reliable data. A comprehensive impact assessment and a further consultation of stakeholders on the basis of clearer definitions are therefore essential to ensure that the full implications of any proposals for separation are fully understood.

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Introduction

The industry has closely followed the debate initiated by the High-Level Expert Group Report ("Liikanen Report"),[2] and the recommendations it made for a safer, more stable and efficient banking system. Given its concerns with some of the content of the Report and the way private equity was referred to and treated, the industry submitted a response to the first consultation of the Commission on the Liikanen Report. The PAE welcomes this new opportunity that the Commission has provided to offer comments, data and analysis on the Services' current thinking.

The current Commission consultation focuses on only one of the several recommendations made in the Liikanen Report, i.e. the mandatory separation of proprietary trading and other high-risk trading activities, and examines the key attributes of the structural reform (i.e. the scope of activities, the strength of separation, and the possible institutional scope). This paper provides general comments on the mandatory separation of bank activities, as well as more specific comments on the ring-fencing scenarios envisaged.

I. Issues regarding the Commission's definition of exposure

1) The Commission's definition

As the Commission notes in its main consultation document, EU banks undertake a wide range of activities. These activities are broadly characterized as ranging from retail and commercial banking activities to wholesale and investment banking. A limited number of examples of activities which would fall in each category are provided. Neither private equity nor venture capital is cited specifically.

The main consultation document ends with a table providing an overview of three options for separation, in terms of both scope and form. Under the most limited scenario for separation, reference is made to "exposures to VC/PE/HF" as activities that should be restricted to the trading entity. Accordingly, in scenario 1 of the template document provided by the Commission only the following activities are to be excluded from the legally separate deposit entity: Proprietary trading; Exposures to venture capital, private equity, and hedge funds; Market making.

The consultation document did not include any definition of "*exposure to VC/PE/HF*" nor any explanation as to why such "exposure" should be separated.

On 11 June 2013, the European Commission updated the consultation documents, in particular the template form and the FAQ. The FAQ includes a question regarding the definition of "*exposure to PE/VC*":

[2] Report of the High-level Expert Group on possible reforms to the structure of the EU banking sector, 2 October 2012.

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> ***"How should banks define exposures to venture capital, private equity and hedge funds?***
>
> *Exposures to venture capital, private equity and hedge funds should be interpreted as covering any debt or equity investment (including through loans or the purchase of units/shares) in different types of alternative investment funds.*
>
> *In other words,* ***any relationship with vehicles for private equity and venture capital activities*** *and with hedge funds should be included (unless it is recorded as proprietary trading or underwriting related activities)."*[3]

It appears that through this explanation, the Commission has sought to clarify that the main concern (and thus the scope of any subsequent separation) relates to banks' direct exposure at the *fund* level, and not to other dealings they may have with private equity-backed portfolio companies or special purpose vehicles.

Nevertheless, even with this statement, it is still not clear what "*exposure to VC/PE/HF*" covers.

2) Differences between types of alternative investment funds

In addition to this general lack of clarity there is a lack of differentiation between each of the sub-categories (venture capital & private equity; hedge funds) mentioned in the Commission's documents. These categories are grouped together with no distinction or recognition of the significant differences there are between venture capital and private equity as one asset class, and hedge funds as another.

The very real distinction between PE/VC funds and hedge funds is one that is already acknowledged by EU law. The Alternative Investment Fund Managers Directive ("AIFMD")[4] recognises PE/VC funds as funds "*that have no redemption rights exercisable during the period of 5 years from the date of the initial investments and that, in accordance with their core investment policy, generally do not invest in assets that must be held in custody in accordance with this Directive or generally invest in issuers or non-listed companies in order potentially to acquire control over such companies in accordance with this Directive, such as private equity, venture capital funds*".[5]

On the basis of this distinction and the specificities of these funds, several options for PE/VC funds have been introduced in the AIFMD, so as to tailor the legal regime applicable to them. This model of differentiation should be borne in mind in the debate on structural reform.

The differentiation between PE/VC and hedge funds is particularly relevant in the light of the suggestions in the 'FAQs' that **the provision of loans** is an example of the relationship between a bank and a fund that should be captured by the separation proposal.

---

[3] European Commission, DG MARKT, Banks and Financial Conglomerates II – Template – Frequently Asked Questions, 11 June 2013, pp. 6-7; our emphasis.

[4] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011, on Alternative Investment Fund Managers.

[5] Cf. Recital 34 and Article 21(3) (c) of the AIFMD.

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In this specific respect – as in others - there are important differences between venture capital and private equity, and hedge funds. Other alternative investment funds, such as hedge funds, use substantial debt at the level of the fund, on a long-term basis. However, in PE/VC funds, debt is typically employed at the level of the operational company, or its holding company (as explained further below in Section II).

3) Further clarification and differentiation is needed

Regrettably, therefore, the FAQ clarification still leaves significant ambiguity. In the first paragraph, it seems very clear that the focus of the Commission is on *funds* (reference is even made to the actual legal term used under the AIFM Directive "alternative investment funds") but the second paragraph departs from this and goes on to state that "*any relationship with vehicles*" (our emphasis) should be included. This second paragraph seems to run counter to the first.

The definition of "*exposure to VC/PE/HF*", therefore, remains unclear and needs significant further work before it could be a basis for policy decisions to be taken.

II. A typology of "exposures to private equity"

Given this continued uncertainty we consider there is a risk that the term "exposure to PE/VC" would include a broad range of activities of very different type and nature. Since a bank may be exposed to private equity and private equity-related activities in a variety of ways, we believe it important to analyse these in some detail to inform the consideration of whether these exposures are relevant for the structural reform debate.

But to understand these exposures some key characteristics of the private equity model need to be made clear:

- Private equity firms establish and manage investment funds that collect capital from multiple investors and pool it in a common vehicle. By pooling capital, investors diversify risk and benefit from the specialist investment skill of the private equity management companies or General Partners (GPs).[6]

- Private equity and venture capital funds are often, but not always, structured as limited partnerships with a contractual limited life, usually of ten years. As Limited Partners (LPs), the investors' liability is limited to the capital they commit to the fund, which is drawn down in tranches as specific investment opportunities arise. The fund is managed by the GP which has unlimited liability. LPs diversify their exposure by investing in a number of PE/VC funds or in funds-of-funds.

- The GP will use the capital raised to buy high-potential companies (the portfolio companies), typically unlisted, private companies. The GP will invest following a clearly defined investment strategy. This can be according to the size of the target companies, their sector, stage of development and/or geographical location. The aim is to help create value in order to realise a capital gain – shared with the owners – on exit.

[6] The European Commission recognised this expertise of managers in its Green Paper on Long-term financing of the European economy, COM(2013) 150 final, 25 March 2013, p. 10.

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1) The four types of exposure

We consider that banks' exposure to PE/VC may be divided into the following 4 categories:

- 1. Banks invest their own capital in private equity funds;
- 2. Banks carry out an asset management function and invest their clients' capital in private equity funds;
- 3. Banks lend to private equity funds;
- 4. Banks lend to portfolio companies for acquisition & business development.

The main characteristics of each exposure are described below; where available, data on the size of these exposures is provided.

1. Banks invest their own capital in private equity funds

Banks have traditionally invested their own capital as an LP in PE/VC funds managed by independent private equity firms. Sometimes, however, banks establish their own PE fund which is managed in-house by a specialist team. Such funds are knows as captive funds. Captive funds are generally established to manage investments of the bank's own capital into unlisted companies.

In both cases the bank is making an indirect investment into unlisted companies (i.e. a private equity investment), seeking to make a return on the deployment of its assets.

As illustrated by Table 1 below, from the banks' perspective, the actual overall size of investments made by banks into *captive* funds is limited: around € 17 billion over the 2007-2012 period.

But from the *private equity* perspective this data also shows the importance of such captive fund investments as a percentage of all private equity investments (6%); and in particular their importance for the growth and venture sectors.

TABLE 1: Investment activity of PE Firms captive to Banks vs. all Private Equity in Europe 2007-2012[7]

	Investments by PE Firms captive to banks (EUR millions)	All Private Equity Investments (EUR millions)	Investments by PE Firms captive to banks as % of All Private Equity (%)
Buyout	11,028	200,544	5%
Growth	3,132	31,406	10%
Venture	3,164	26,684	12%
Total	17,323	270,763	6%

[7] Source: EVCA\PEREP_Analytics.

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Furthermore, as Table 2 shows, the importance of banks' captive funds varies significantly from one Member State to another. In 2012 7% of total European private equity capital under management came from PE firms captive to banks. However, there is a significant range: from just 1% in Sweden, to 18% in Spain and 29% in Portugal. This illustrates how structural reform implemented at the EU level will not have the same impact in all jurisdictions.

TABLE 2: Exposure of banks to captive PE funds by capital under management (2012)

CuM Banks			
Country of GP	Total PE assets in a bank captive fund (EUR Million)	Total PE assets (EUR Million)	Bank captive funds as a % of total capital under management
Portugal	1 107	3 829	29%
Croatia	80	359	22%
Germany	5 560	29 755	19%
Italy	3 326	17 939	19%
Spain	2 772	14 989	18%
Austria	539	3 307	16%
France	13 246	82 757	16%
Greece	114	1 025	11%
Luxembourg	277	2 625	11%
Belgium	794	9 437	8%
Poland	342	4 143	8%
Hungary	42	784	5%
Netherlands	932	19 604	5%
Latvia	15	325	5%
Ireland	134	3 189	4%
United Kingdom	9 254	258 934	4%
Denmark	130	8 361	2%
Norway	115	9 864	1%
Switzerland	122	14 301	1%
Sweden	281	39 011	1%
Finland	5	5 699	0%
Grand Total	**39 187**	**533 631**	**7%**

Taking the data in Tables 1 and 2 together, it becomes clear that structural separation would be likely to hit venture and growth capital investments in some Member States much more than in others, with an inevitable impact on their prospects for growth and job creation.

2. Banks carry out an asset management function and invest a client's capital in private equity funds

Banks may also invest in PE/VC funds managed by independent private equity firms by performing an asset management function and simply executing a *client's* instructions on where to invest his funds. As this is the equivalent of any other asset management function it should be treated as such in the debate on structural reform.

The Scale of Banks as Investors

Although there is a clear distinction between the bank managing its *own* investments in PE/VC funds (captive or not) and the bank managing its *clients'* assets in PE/VC funds, industry data tends to be aggregated, making it difficult to distinguish between them.

It is, though, clear from graphs 1 and 2 below, that while the relative importance of banks as investors in PE/VC funds has been steadily decreasing since 1990 (reflecting in part the increased

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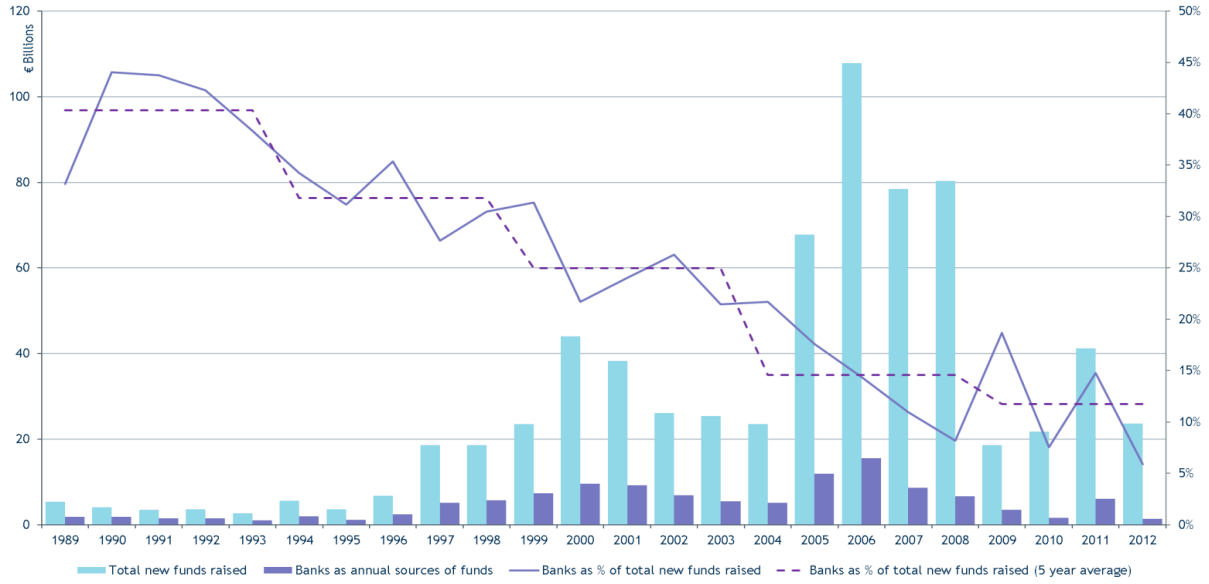
investment by other institutional investors in PE/VC funds) they remain an important part of the investor base.

In terms of absolute amounts invested, however, banks' exposure to PE/VC funds grew until 2006, but has significantly reduced since then. The trends seen in these graphs are not only a reaction to the financial crisis, but also reflect other factors, including uncertainty surrounding the impact of capital requirements when banks invest in private equity.

A structural separation in which *all* "exposures to VC/PE" would be assigned to the trading entity risks a further reduction in such investment, and thereby risks impacting on the ability of PE/VC funds to finance European companies.

GRAPH 1 – Funds raised overall and from banks (1989-2012)[8]



[8] EVCA Research analysis.

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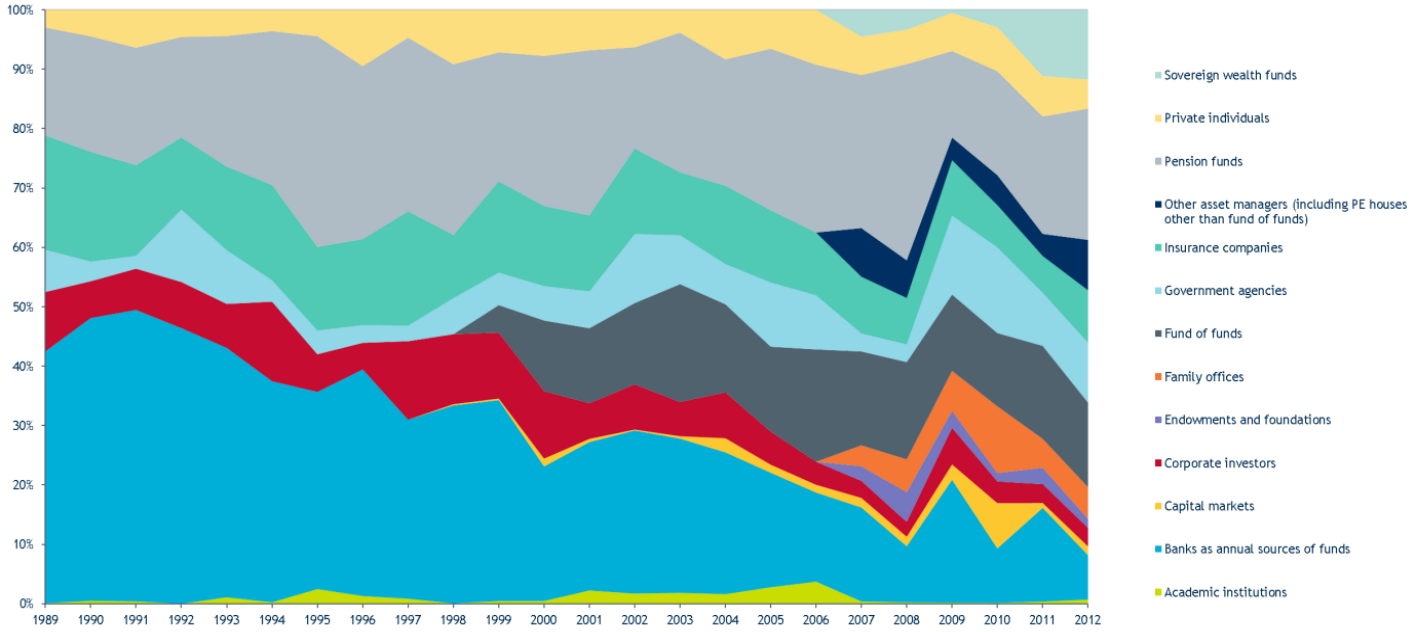
GRAPH 2 – Fund raising by types of investors (1989-2012)[9]



3. Bank lending money to a PE Fund

Another potential exposure that banks might have to private equity consists of cases where banks lend directly to investment funds.

Borrowing is typically contractually prohibited at the fund level, but in limited cases it is permitted. Such borrowing typically takes place on a short term basis for a few very specific purposes. Where the fund is waiting for investors to transfer a tranche of the capital that they have committed, a credit facility might be used as a short term bridge to enable a swift signing and closing.[10] Short term borrowing may also be used when a fund intends to syndicate part of its holding right after acquisition to co-investors (be they fund investors taking a direct ownership or other investors). Rather than first drawing and then, upon syndication, returning funds to investors (which implies a cost) the fund will use the credit facility to bridge this tranche to be syndicated. If the syndication does not happen (or not fully), the fund will draw down the necessary capital to repay the bridge loan.

The borrowing facilities are agreed with the bank for the duration of the life of the fund, but the borrowing is typically limited in time and in amount. As outlined in both cases above, the capital committed by the investors is used to secure the borrowing. Since investors will have had to make a legally binding commitment to provide pre-determined levels of capital upon call by the GP, a loan of this type would be short-term.

[9] Source : EVCA\PEREP_Analytics.

[10] In draw-down notices, the capital is generally due within 10-15 business days.

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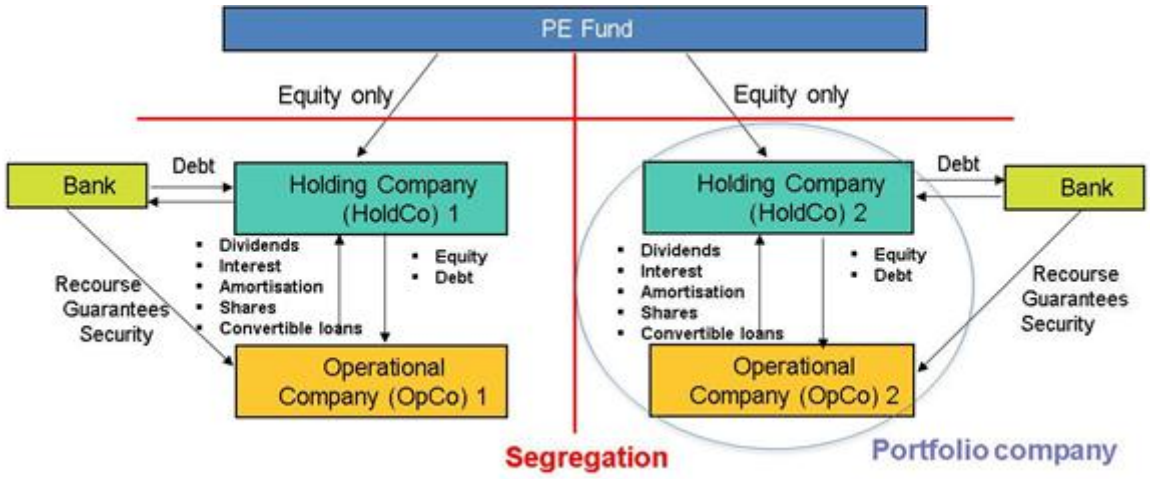
The amounts borrowed at fund level for these purposes are therefore typically capped and secured for their duration against the undrawn, legally-binding commitments of investors, and therefore do not create exposure at fund level. This exposure does not give rise to any concerns from a systemic risk or macro stability perspective and such short-term lending, fully backed by the committed capital of investors, should not be prohibited from the deposit-taking entity.

4. Bank lending to a portfolio company for acquisition & business development

In this type of exposure, the bank simply extends a loan to a private equity-backed portfolio company. This is directly equivalent to bank lending to any other corporate held by any type of owner, and does not impact on the private equity fund. This lending may be to enable the portfolio company to further develop or be undertaken in the context of an acquisition.

As the chart below demonstrates, this lending is not made to the private equity fund, but to the portfolio company (or a holding company). The PE/VC fund is not exposed (directly or indirectly) to any debts that the portfolio company might have, and each portfolio company only carries its own debt, without the fund having any subsequent exposure. Each portfolio company collateralizes its own debt, and should that portfolio company default, there is no impact on any other portfolio companies in which that private equity fund has invested, nor any obligation to make whole neither on the fund nor on its investors.

CHART ON PE STRUCTURE



From the perspective of the bank, therefore, lending to a portfolio company that is backed by private equity is the same in all key respects as lending to a company with any other ownership structure. Typically the bank will have had a long-standing relationship with the company as such, irrespective of who from time to time may be the owner (entrepreneur, consortia of angel investors, PE fund, institutional and private investors after IPO, etc). The lending is secured since it is typically subject to the provision of collateral. As a consequence the risk that the loan is not repaid, which is the main risk faced by the bank, is one that the bank can consider and manage as it would with any other corporate loan.

The bank will take a view, for example, on the cash-flow generating capabilities of the portfolio company group and any collateral it is providing and on the strategy it intends to take to grow and develop. The fact that the ultimate owner of the portfolio company may be a private equity fund – rather than, for example, some other form of private owner – will not change the detailed credit analysis processes that the bank needs to undertake. The final decisions of the bank will be taken after thorough examination of all these factors and discussions within the same credit

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committee structures that consider any other corporate lending. In the context of the structural reform debate there is therefore no reason to treat bank lending to private equity-backed companies any differently to lending to other corporates.

There is good evidence to suggest that when a bank is lending money to a private equity-backed company, the individual exposure and the risks are the same or even lower than for equivalent lending to a non-PE backed company.

Several studies have found that private equity-backed companies generally have better corporate recovery and survival rates.[11] The default rate for private equity-backed companies is *lower* than for similar publicly-owned companies.[12] And more broadly the default rate for private equity-backed companies is *lower* than for non-private equity-backed companies.[13] 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-PE backed companies.

When a bank is "exposed" to private equity as a result of lending to a company which happens to be in private-equity ownership, there are no grounds to believe that this is a higher risk than lending to a business with any other form of ownership. Since corporate lending activity to non-private-equity backed firms would typically be assigned to the deposit-taking entity within the banks, there is no case to require bank lending to portfolio companies to be excluded from the deposit-taking entity. This consistency of approach would also avoid the perverse – and, for the portfolio company, disruptive - situation in which a company was forced to shift its banking relationship from one entity to the other (and back again) as it made the transition into and then back out of private equity or venture capital ownership.

III. The risks of private equity exposures are appropriately mitigated and do not require further regulation

As Section II above demonstrates, the characteristics of the various exposures that exist can be clearly identified and the legitimacy of their execution by a deposit-taking entity can be justified.

Critically, any risks to which they give rise are also already appropriately mitigated, both from the banks' perspective and from the investment funds' perspective. A comprehensive set of supervisory and regulatory tools are already in place and deliver the core objectives that a structural separation would look to offer. When considered as a whole, the requirements of the AIFM Directive; current market or industry practice and norms; and the current legislation and regulation which apply to the banking sector provide a comprehensive set of tools to manage and mitigate any risks arising from banks' "exposure" to PE. The additional step of structural separation therefore needs to be justified.

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[11] Cf. Frontier Economics Report, *Exploring the impact of private equity on economic growth in Europe*, May 2013.

[12] Study by the Bank for International Settlements (2008), looking at leveraged buyouts globally between 1997 and 2001, suggests that the failure rate for private equity-backed companies is at least 5% lower than similar publicly owned companies.

[13] Up to 25% lower than for non-PE backed companies, according to Kaplan and Strömberg (2009). This study was based on 3,200 businesses in Europe.

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1) The impact of AIFMD

Risks to the stability of the financial system from banks' exposures to private equity funds are addressed in the AIFMD.

The AIFM Directive recognises that while it is possible for some funds to contribute to the build-up of systemic risk or disorderly markets, this is only the case **where they employ leverage**. The AIFM framework (the Directive and the Delegated Acts) defines leverage and how it is to be calculated and monitored. Where necessary for reasons of systemic risk, it provides the competent authorities with the power to limit the fund's leverage.

Leverage of an AIF is defined as the ratio between its exposure and its net asset value.[14] Leverage may consist of any method by which the AIFM increases the exposure of an AIF it manages, whether through borrowing of cash or securities, leverage embedded in derivative positions, or by any other means. It is also clearly stated in the case of PE funds that **leverage that exists at the level of a portfolio company does not increase the exposure of the AIF**.

A further distinction is introduced in the regulatory framework between "leverage" and "substantial leverage": substantial leverage occurs when the exposure of an AIF exceeds three times its net asset value.

The AIFM Directive provides tools for monitoring and addressing any potential systemic risks that could arise from any fund leverage. Managers must provide information about the exposure of funds to both competent authorities and investors. Where the stability and integrity of the financial system may be threatened, **the competent authorities have the power to impose limits on the level of leverage that an AIFM can employ in AIFs it manages**.

This power, therefore, provides supervisors with a robust tool to intervene if fund leverage threatens financial stability.

The importance of 'leverage' as an assessment of risk has been recognized in the Regulation on prudential requirements for credit institutions and investment firms.[15] It has also been recognized in the debate in Germany on structural reform of the banking sector. The German law on the reform of the banking sector uses "substantial leverage" as a key criterion to distinguish between activities which can stay with the deposit-taking entity, and those which need to be separated.

We believe that the German approach is a sound one, as it builds on the approach taken by the EU co-legislators in the AIFM Directive, using "substantial leverage" as an indicator of potential systemic risk.

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[14] Article 6(1) of Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (« the Delegated Acts »).

[15] The reference to leverage is used in Article 128 CRR when referring to exposures « *associated with particularly high risks* », whereby only investments in leveraged alternative investment funds are considered as high risk and subject to a higher risk-weight. See sub-section 3 below for further explanation on the prudential rules applicable to banks.

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2) Market / industry practice

When banks act as investors (LPs) in PE/VC funds, they can rely on EVCA Risk Measurement Guidelines, which represent current best practices to measure the value at risk of investing in private equity and venture capital funds.[16] They also follow traditional portfolio construction practices to build balanced and diversified portfolios of funds in order to mitigate risk.

The private equity model is built in such a way that there is a strong alignment of interest between LPs and GPs. LPs access private equity via 10-year, closed-end limited partnerships (or similar structures)and make a legally-binding commitment at the start of the fund's life to invest a defined amount into the fund without redemption rights. In addition, the GP also invests directly into the fund, becoming a "co-investor". And with the GP's gains linked directly to the actual return that investors receive, this ensures a clear and strong alignment of interest between the manager of the assets and the investors, whether they are banks or any other form of investor.

Finally, when banks provide debt as part of a private-equity acquisition or for the business development of a PE-backed company, they operate in line with the relevant best practices, assessing the collateral and the overall context in which the loan is to be provided. Market and industry practice therefore contribute to the mitigation of risks.

3) New regulation and supervision

The High Level Expert Group made several recommendations to reform the banking sector, besides the ring-fencing of activities. These alternative proposals have been taken into account and are reflected in two important legislative proposals which are currently under discussion or have been recently agreed upon, and which significantly affect the way banking activities take place:[17]

- The Bank Resolution and Recovery Directive (BRRD)[18]
- The Capital Requirements Directive/Regulation (CRD IV / CRR).

The BRRD would provide for the potential separation of some activities within banks, as well as several tools to protect tax payers (bail-in procedures). The separation in the BRRD and the bail-in tools are more proportionate, tailored and risk-sensitive than a structural reform, while efficiently contributing to reaching the objectives of efficiency, stability of the banking system and protection of tax payers.

The EU legislators have recently agreed on CRD IV / CRR, which framework defines the prudential requirements which will apply to credit institutions. Among the new rules:

- Banks will be required to hold more and better capital (tightened definition of core capital, increase of minimum requirements, re-assessment of the risk-weights applicable, see below);

[16] Cf. EVCA Risk Measurement Guidelines, January 2013.

[17] The BRRD is yet to be agreed upon, and CRD IV /CRR will apply as of 1 January 2014, but banks have already started to adapt to the newly adopted rules.

[18] See Commission Proposal for a directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms.

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- Liquidity requirements have been introduced (liquidity coverage ratio and net stable funding ratio);

- A non-risk weighted leverage ratio has been introduced;

- New corporate governance rule are to be implemented by banks.

All these new requirements contribute to the banks being safer and more stable. Regarding the treatment of exposures to PE/VC, the key provisions are those regarding capital requirements.

For the sake of calculating their capital requirements, banks are under the obligation to calculate risks (including credit risk, market risk, counterparty risk…) for each type of exposure, depending on whether an exposure belongs to their banking book or their trading book. We note here that by their nature, investment in PE/VC funds (which are closed-ended vehicles), whether captive or non-captive, typically belongs to the banking book (i.e. there is no intent to trade). It would therefore seem counter-intuitive, and to contradict the approach taken in CRD IV /CRR, to require such non-trading exposure to PE/VC to only be undertaken by the trading entity.

When calculating credit risk, banks may choose between two approaches: the Standardized approach (SA), or the Internal Rating Based approach (IRB).

Under the SA, a specific risk weight is defined for each category of exposure, including investment in shares or units of collective investment undertakings (e.g. private equity funds). Under the IRB, a bank may rely on a more sophisticated model: either via general authorization by the national supervisor or via a specific authorization of the internal models developed by the bank and the way risks are addressed for each asset class. There is thus *specific and appropriate* risk-weighting in place for investments by banks in private equity funds.

Taken together, these aspects of the new capital regime have clearly put in place a detailed regulation and supervision of any credit risk to which a bank is exposed from the business it does with private equity clients.

In addition, in the context of the current consultation launched by the Basel Committee on Banking Supervision, these capital requirements are subject to a review to ensure that they properly allow for both underlying risks and leverage to be taken into account. The Basel Committee on Banking Supervision thus published on 5 July 2013[19] a set of proposals that would revise the prudential treatment of banks' equity investments in funds. The objective being to reinforce an appropriately risk sensitive and consistently applied risk-based capital regime.

Other forthcoming measures at EU level will also have a significant impact on the soundness of the banking sector and better protect taxpayers:

- Measures to better guarantee deposits;

- Measures to improve transparency and address the risks of derivatives,

- The proposals related to Banking Union (the Single Supervisory Mechanism and the Single Resolution Mechanism): these proposals can also contribute towards financial stability by providing more coherent and coordinated approaches to bank oversight.

[19] Basel Committee on Banking Supervision, *Capital requirements for banks' equity investments in funds*, July 2013.

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All these changes to the legal and regulatory framework are being supplemented by more active supervision of *all* financial institutions in Europe, whether of alternative investment funds by the national competent authorities or of credit institutions by national banking supervisors, and for those participating in Banking Union, the ECB.

4) The cumulative impact of new financial regulation

The comprehensive reform agenda outlined above and on which the European Union is working is delivering a robust set of tools for addressing any concerns that there might be over the relationship between banks and private equity and venture capital.

The AIFM Directive approaches the issues by looking at the *funds*, putting in place a set of detailed requirements for how they should operate and providing supervisors with the power to intervene and restrict a fund's leverage should it become a cause of systemic concern.

In tandem, a revised regulatory and supervisory regime is being put in place that takes the *banks* as the starting point, reinforces their capital requirements, introduces liquidity requirements, improves the mechanisms for their recovery and resolution, and enhances their supervision.

This twin-track approach is the right one. It both looks in detail at the activities of banks' individual private equity clients *and* ensures that individual banks (and the risks they may face) are considered in the round. With both of these tracks in place and operational, **we see no case for the additional – and by definition undifferentiated and rather blunt – step of requiring the separation, in all circumstances, of all private equity and venture capital business from other banking activities being undertaken by a deposit-taking entity.**

IV. Implications of the separation: impact on the European economy

The spirit of the Liikanen Report was to help to establish "*a more stable and efficient banking system serving the needs of citizens, the EU economy and the internal market*". The same key driving factor is seen in the structural reforms undertaken in France and Germany. It is also the underpinning principle in the Report released in the Netherlands, as evidenced by its title.[20]

As the debate continues at EU level, there should be a similar willingness to take fully into account the implications of any structural reforms to banking for the European economy and its capacity to deliver growth and jobs. Without this consideration, there is a real risk that private equity and venture capital will be constrained in its ability to invest in European business.

1) The role of private equity in the EU Economy

As evidenced in various reports and studies by the European Commission and the European Central Bank,[21] one of the key issues and most pressing needs for European SMEs today is **access to finance**.

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[20] *Towards a serviceable and stable banking system* ; Report from the Commission on the structure of Dutch banks, June 2013.

[21] According to recent European Commission – European Central Bank joint studies on SMEs, challenges in access to finance are among the top concerns of SMEs (15%). An even higher proportion of SMEs (those less

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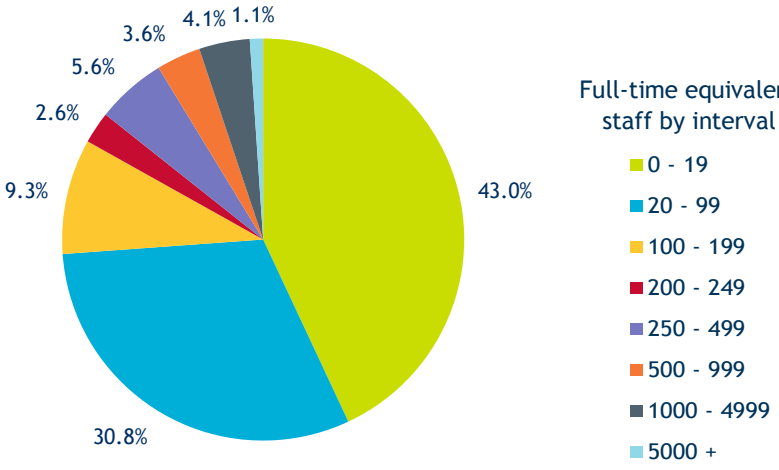
SMEs are crucial for economic growth, job creation and exports. They currently account for two out of three jobs in the private sector and are responsible for more than half of the total value added by EU enterprises. In the period 2002 to 2010, they were responsible for 85% of net new jobs created in the EU. As dynamic enterprises, they are significant contributors to innovation, breakthrough technologies, and economic growth.

Private equity recognizes this and is an important potential source of SME finance. In 2012, private equity invested around EUR 40 billion in approximately 5,000 companies in Europe. 83% of all PE fund investments are in SMEs and this is investment that yields real benefits for the economy.

A recent study[22] shows that, on average, private equity-backed SMEs had an annual growth rate of 7% over a four year period, compared to an average growth rate of around 2% for all European SMEs.

And it is not just SMEs that benefit from private equity support. Private equity invests in companies across all of the stages of their development (see graphs 3a and 3b below).

GRAPH 3a: PRIVATE EQUITY INVESTMENT IN 2012 - % OF NUMBER OF COMPANIES[23]



than 5 years old) actually mentioned « access to finance » as their most pressing problem (around 20%). Cf. http://ec.europa.eu/enterprise/policies/finance/data/index_en.htm. For additional statistics, see Eurostat, SMEs' access to finance survey (2007-2010).

[22] Professor Christoph Kaserer, "*Return Attribution in Mid-Market Buy-Out Transactions - New Evidence from Europe*", Center for Entrepreneurial and Financial Studies, Technical University of Munich (October 2011).

[23] Source : EVCA/PEREP_Analytics.

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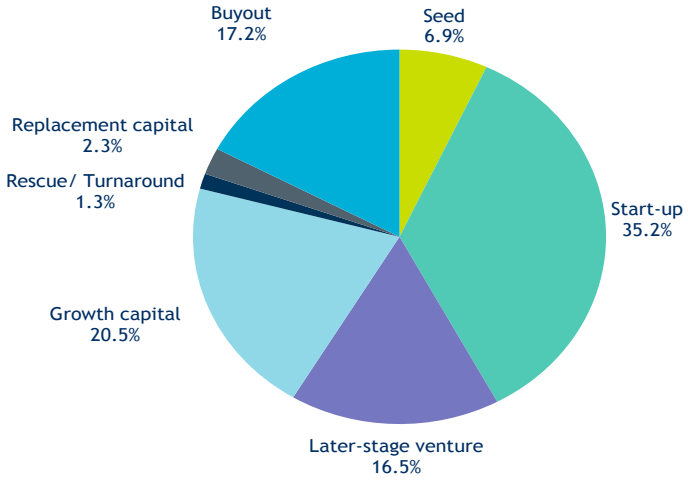
GRAPH 3b: Investment by Stage Focus – 2012[24]

% by Number of companies



Venture Capital	**2,923 companies**
Buyout	**878 companies**
Growth	**1,047 companies**

Private equity not only invests across all stages, it also invests in a broad range of industrial sectors. And regardless of the sector or the company's size or stage of development, private equity owners become relatively long-term owners of the companies in which they invest, staying invested for an average of 5 years.

There is now compelling and consistent evidence of the variety of ways that private equity's model of active ownership can enhance companies' long term development, during their different stages and across functions:

- *Innovation*: private equity investments are notably successful at stimulating innovation and in particular contribute to a significant increase in patent filings[25]

- *Access to Finance*: following a private equity majority investment, companies are typically able to increase their capital expenditure and become more profitable than their competitors[26]

- *Productivity*: private equity investments in large European companies improved the latter's productivity by 7% per year[27]

[24] Source: EVCA/PEREP_Analytics
[25] Popov and Roosenboom, 2009, ECB Working Paper
[26] Boucly et al 2011., Journal of Financial Economics
[27] Ernst and Young., 2012

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- *Operational Improvement:* approximately 66% of the value created by private equity investments comes from operational improvement, in particular from sales growth, improved margins and freed up cash which then becomes available for, for example, value enhancing operational investments or debt repayments[28]

- *Venture capital injects economic dynamism:* an increase in venture capital investments of 0.1% of GDP is statistically associated with an increase in real GDP growth of 0.30 %. Early-stage investments have an even bigger impact of 0.96 %[29].

- *Venture capital-backed companies benefit from sales growth:* Venture capital has an "unequivocally positive" impact on the productivity and growth of companies, particularly when investment is received at seed stage[30].

2) Risks and impact of a separation of PE/VC related activities

Given the above, if all PE/VC related activities of banks were indiscriminately assigned to the trading entity and/or excluded from the deposit-taking entity, and given the fact that each entity would have to comply with the capital requirements under CRD IV/CRR, it would be more costly for banks to support PE/VC.

As a result, the cost of funding for PE/VC funds would be raised and/or availability would be curtailed, restricting the ability of PE/VC to invest in the growth and development of European businesses. A separation would reduce the future ability and willingness of banks to continue to lend to European companies with a private equity or venture capital owner, restricting the ability of such companies to grow, or potentially even jeopardising their survival.

It is not only PE funds *future* investments into European SMEs which may be compromised, but also the refinancing of company debt. Private equity - like other forms of ownership - will use debt as one component of the strategy for acquiring and then developing a company. This debt component will periodically be refinanced, perhaps to reduce the overall financing costs of the company or to give it more time to develop and grow.

As PE fund managers invest in new companies and exit current investments the amount of debt will rise and fall. Debt will usually be structured in line with the planned holding period of the company (on average 5 years), and while there will be a target date for the investment to be exited, this cannot be known with certainty. It may therefore be necessary for existing debt at the level of the portfolio company to be extended to take account of such market developments.

Private equity-backed companies, like companies under other ownership models, therefore need access to the financing that will enable them to manage their debt. Given the critical importance in Europe, in comparison with the USA, of banks as a source of financing, any reforms to the structure of banking that make it more difficult for these companies to manage and refinance their debt could have serious implications.

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[28] Kaserer C., 2011, Return Attribution in Mid-Market Buy-Out Transactions

[29] Deutsche Bank Research, 2010

[30] VICO, 2011

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Conclusion

The private equity and venture capital industry makes a powerful contribution to the European economy, investing across the EU, across sectors and in businesses of all sizes. It is a mature industry that is playing its part in helping to deliver growth and jobs in the EU. But the ability of this industry to make its contribution could be hampered by disproportionate regulation, in particular in relation to the structure of banking.

We strongly believe that before any formal legislative proposal is produced a thorough and detailed impact assessment needs to be undertaken, based on clear definitions of which activities are to be assigned to which entity. In particular it is important to carefully assess the complementarity of structural reform with the new EU banking framework before taking a decision on separation.

Such an analysis would also need to differentiate between PE/VC on the one hand and other alternative investment strategies such as hedge funds on the other hand, which are quite different and distinct activities.

Without such a comprehensive analysis, based on clear definitions, we believe that it is not possible to justify a broad exclusion of banks' engagement with private equity of the sort that is implied by the European Commission's consultation paper.

We are particularly concerned to ensure that private equity as an ownership model is treated fairly in comparison to other forms of corporate ownership. Where a bank is engaging with a private equity-backed company in a manner that is directly analogous to its engagement with any other corporate, there is no case for differences of treatment. Nor should a deposit-taking entity be prevented from executing a client's instruction to invest his capital in a private equity fund, in the same way as it would execute its asset management function in any other asset.

The case for a blanket prohibition on a deposit-taking entity engaging with the private equity and venture capital industry needs to be justified, based on clear evidence of potential risk and clear evidence that the existing regulatory framework does not already mitigate this.

Banks play an important role – whether as investors, asset managers or lenders – in enabling private equity and venture capital to develop and grow European companies and deliver jobs. The structural reform debate must not ignore the benefits this relationship brings.

Submission

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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 EVCA

The EVCA is the voice of European private equity.

Our membership covers the full range of private equity activity, from early-stage venture capital to the largest private equity firms, investors such as pension funds, insurance companies, fund-of-funds and family offices and associate members from related professions. We represent 650 member firms and 500 affiliate members.

The EVCA shapes the future direction of the industry, while promoting it to stakeholders such as entrepreneurs, business owners and employee representatives.

We explain private equity to the public and help shape public policy, so that our members can conduct their business effectively.

The EVCA is responsible for the industry's professional standards, demanding accountability, good governance and transparency from our members and spreading best practice through our training courses.

We have the facts when it comes to European private equity, thanks to our trusted and authoritative research and analysis.

The EVCA has 25 dedicated staff working in Brussels to make sure that our industry is heard.