Submission

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

04 October 2013

To Basel Committee on Banking Supervision

Re Response to the Consultative Document "Capital requirements for banks' equity investments in funds" (HT. 3053)

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Introduction

The Public Affairs Executive (PAE) of the European Private Equity and Venture Capital industry welcomes the opportunity to respond to the Basel Committee on Banking Supervision (the "BCBS") consultation "Capital requirements for banks' equity investments in funds" (the "Consultation").

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, including the institutional investors investing in a broad range of PE/VC funds, as well as the PE/VC firms raising such funds, which in turn invest in the full life-cycle of unlisted companies, from high-growth technology start-ups, to the largest global buyout funds turning around and growing mature companies, and thus we speak on behalf of the entire European PE/VC industry, investors as well as managers.

For many years, the EVCA has worked to produce best practices to help measuring the value at risk of investing in PE/VC funds, and has followed closely the different discussions and initiatives regarding capital requirements for investors affecting the European private equity ("PE") and venture capital ("VC") industry.

In this response, we provide first a general presentation of the PE/VC model and how it invests in companies. We then provide general comments on the proposals made by the BCBS regarding capital requirements and answers to the questions asked in the Consultation.

We stand ready to provide whatever further contribution to this work the BCBS might find helpful, including attending meetings and contributing further materials in writing.

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1. General presentation of private equity

a) Presentation of private equity

The primary avenue for institutional investment in private equity is the limited partnership of 10-12 years duration, usually comprising a number of institutional investors (limited partners) and the fund manager (general partner).

These limited partners (banks, but also pension funds, insurers, fund of funds) typically gain exposure to private equity by investing in a portfolio of funds, which is diversified, by vintage year, geography and stage of investment from early stage venture capital and growth equity, up to larger buyout funds.

Private equity is a long-term investment, which takes time to mature. Fund structures in private equity have been specifically designed to reflect this long-term characteristic. They are not designed to be traded like a liquid asset, or for investors to withdraw during the life of the fund, and often this is expressly excluded by the legal agreements at the heart of the fund. Funds are usually structured to have a minimum life-span of 10 years to ensure that the underlying companies in which investments are made have the time and potential to grow and develop further.

Investors participate by making a legally binding commitment to invest a specified amount of capital in the fund - entitling them to a proportional share of fund interests - with no obligation to increase their investment beyond this. They invest with the intention of remaining invested for the full life of the fund, and closed-end funds in the private equity industry usually specify from the outset that investors have no right of redemption before the end of the life of the fund.

The fund manager then draws from this capital pool to fund the acquisition of stakes (often controlling) in a number of portfolio companies over the course of the fund's investment period. The fund manager seeks to increase the value of the portfolio companies through long-term active ownership management exercised via the boards of these companies and exits these investments at a time deemed appropriate. The proceeds from divestitures are distributed to the limited partners.

An investor's average net invested capital (or capital at risk) is measured by the paid-in amount minus distributed capital. The capital at risk is therefore invariably much lower, on average, than the investor's overall legal commitment to the fund.

This is because funds often start making distributions to investors before having drawn down and invested the entire commitment. In addition, proceeds from

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realizations can be used to fund that part of the investor's commitment still to be drawn down.

Studies show that in a normal market environment the maximum proportion of capital at risk during the life of a fund is only around 60% of the commitment made by the investor. In extreme scenarios, this number can reach up to 85%, but this would be untypical.[1]

b) Understanding the specific characteristics of investor's risk in PE

We believe it is crucial to bear in mind the unique characteristics of private equity investing when determining the most appropriate method of calculating capital requirements for investments by banks into this asset class.

In order to help investors understand these unique characteristics and measure in an appropriate way the risks associated with their investment in private equity, the industry has produced Risk Measurement Guidelines (the "Guidelines").[2]

These Guidelines are intended for investors (banks, insurance companies, pension funds, fund-of-funds, etc.), which act as limited partners in private equity and venture capital funds. Their focus is the measurement of risks for investments through closed-ended funds with a finite life structured as limited partnerships, which is the dominant and most relevant vehicle for institutional investing in private equity. The Guidelines take full account of the specificities of PE/VC funds and identify the risks which should be considered by institutional investors.[3]

The industry felt there was a need to provide professional standards and guidance to help investors develop sound risk measurement practices and to inform discussions on risk measurement with regulators. Since the beginning of 2010, an EVCA Risk Working Group has developed a first set of private equity risk measurement guidelines to enable the development and regulatory approval of model-based risk measurement.

This EVCA Risk Working Group comprised experienced industry practitioners from leading institutional private equity investors. Additionally, the working group

[1] Meyer and Mathonet – Beyond the J-Curve (2005).

[2] EVCA Risk Measurement Guidelines, January 2013.

[3] These may include liquidity risks, funding risks, etc.

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sought independent review, feedback and support by an academic advisory board.[4]

Therefore, the Guidelines, which were drafted by a group of risk measurement practitioners in dialogue with academics, document views and methods that have found *broad acceptance*.

2. General comments

a) The objectives and methodology of the BCBS proposal

We understand the general objective of the Consultation to be to clarify how banks should calculate capital requirements that apply to their investments in the equity of all types of funds. In addition, it is explained in the Consultation that the current model(s) for calculating capital requirements does not reflect the relevant fund's leverage, even though leverage is deemed to be an important risk driver for these investments. The Consultation therefore aims at clarifying the calculation of capital requirements and at integrating leverage into this calculation.

The Consultation's approach is outlined in 6 steps: i) the scope of application, ii) the scope of consolidation and deductions from capital, iii) the policy framework, iv) the incorporation of leverage into the framework, v) the resulting capital requirements and vi) the introduction of a cap.

Regarding the *scope of application*, the Consultation appears to address banks' equity investments in all types of funds. However, we note here that the Consultation does not distinguish between open-ended and closed-ended fund structures. In particular, the Consultation does not appear to recognize that closed-end funds, including private equity funds, generally do not face redemption risk and, as such, could present comparatively lower risk to a bank investor.

To identify the underlying assets whenever investing in investment funds, the BCBS assumes in the Consultation that the look-through approach ("LTA") should be used as a starting point. This approach requires banks to risk weight the underlying exposures of a fund *as if* the exposures were directly held. For banks relying on the Internal Ratings-Based approach, the risk components must be

[4] This Academic Board comprised independent academics who are leading in private equity research and have a strong international network. The Academic Board reviewed the Guidelines and the various comments received from the industry. The draft Guidelines were indeed open to consultation and feedback of the industry.

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calculated using the Probability of Default ("PD") of the underlying exposures and, where applicable, the relevant Loss Given Default ("LGD") and/or Exposure at Default ("EAD").

The two alternatives to the LTA are the mandate-based approach (the "MBA") and the fall-back approach (the "FBA"). Since risk sensitivity decreases with each of these successive approaches, the degree of conservatism increases also with each approach, and heavier risk weighting applies as one progresses from the LTA, to the MBA and to the FBA.

After having chosen and applied the relevant approach, the Consultation then offers two options to calculate the capital requirements: applying the leverage adjustment either to the average risk weight of the fund; or to the total risk-weighted assets of the fund, subject to a cap under certain conditions.

b) General remarks

The industry welcomes a clarification of the rules applicable to banks' equity investments into funds and the consultation of stakeholders. However, we feel that the Consultation's approach could result in an inaccurate assessment of the actual risks associated with bank investments in private equity funds.

The PAE supports the BCBS efforts to better understand the nature and characteristics of bank investments in private equity funds. That said, the PAE is concerned that the Consultation could potentially impose unduly excessive capital requirements on banks' investments in private equity funds that do not reflect their actual risks. Banks could respond to poorly calibrated capital requirements by selling private equity assets, which could have a negative impact on their balance sheets and the diversification of their investment portfolios without corresponding improvement in their safety and soundness.

The industry is concerned that the Consultation's approach could produce inaccurate capital requirements for bank investments in private equity funds, because:

(1) it fails to account for the risk-mitigating benefits of diversification, i.e., the fact that bank investors generally hold a diversified portfolio of private equity fund investments,

(2) the focus on leverage does not reflect the characteristics of PE: a typical private equity funds has no leverage at the fund level. Companies into which private equity invests may use leverage, which they reduce over time.

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Taking these issues in turn:

(1) Benefits of Diversification

Banks and other investors generally hold diversified portfolios of private equity investments, which mitigate the overall risk of the fund portfolio. Indeed, for a given diversified portfolio of funds, the significant upside of fund investments performing well will generally compensate for the losses of funds which would not return the entirety of the commitments drawn.

But the Consultation appears to give little consideration to the substantial risk-mitigating benefits of diversification in the private equity context. Since a typical private equity investor (including bank investors) invests in dozens of private equity funds, with each fund in turn holding more than a dozen portfolio companies, a typical private equity portfolio easily consists of several hundred portfolio companies, which will have been acquired at different points in time, in various geographies, and at various valuations.

Through the diversification at the level of portfolio companies, the individual private equity fund is able to generate a positive return for the investor even if an investment in an individual portfolio company yields a loss.

There is academic evidence that private equity fund investments are not normal distributed, but right-skewed. In other words, the statistical distribution of investment outcomes for private equity has fat tails on the positive side of the distribution: a private equity fund would need only one high-performing portfolio company in its portfolio (a “Google” or “Jack Wolfskin”, for example) in order to make a highly positive return for the fund investors. A model based on credit risk, as per the BCBS paper, only assumes a maximum return of 1x. However, the majority of private equity company returns are between 1x and 3x capital.[5] The Consultation does not appear to take this distribution of returns into account, with the potential result being poorly calibrated capital requirements that do not reflect the actual risks facing an investing bank.

The LTA is seen as equivalent to the bottom-up approach, i.e. the fund’s risk needs to be constructed by adding up the individual portfolio companies’ risks. We do not believe the LTA is appropriate for application to bank investments in private equity, as it fails to account for diversification, and could potentially increase compliance burdens (given the dynamic nature of companies and the absence of ratings for many of them), without corresponding regulatory benefit.

The high degree of diversification – both at fund level and then at portfolio company level - is very important for assessing the risk of private equity

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[5] Robert S. Harris, Tim Jenkinson and Steven N. Kaplan, 2013. Journal of Finance forthcoming. July 2013. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1932316.

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investments generally, including from the perspective of bank investors. As noted previously, investors have committed to invest for the long-term as the agreements into which they enter do not provide for investments to be sold or redeemed with the fund manager.

The large degree of diversification combined with the real prospect of reaching very positive fund returns at the aggregate level reduces the risk of bank investments in private equity funds, and should be reflected in any approach for determining regulatory capital requirements for these investments.

(2) BCBS focus on leverage

A typical private equity fund has no leverage at the fund level and we feel that this feature of the asset class is not appropriately reflected in the Consultation. In particular, the PAE is concerned that the Consultation does not take explicit account of the fact that private equity funds generally have no leverage, and therefore present comparatively lower risk to bank investors.

To this end, we think that the Consultation should make clear that it is concerned with leverage that may exist at the *fund* level (which, as noted, does not exist with respect to private equity funds) as opposed to leverage that may arise at a *portfolio company/operating company* level (which is separate and distinct from the fund level).

With respect to the treatment of leverage, the BCBS may wish to consider the Alternative Investment Fund Managers Directive (the “AIFMD”).[6] The European Union developed an approach to the definition and calculation of leverage in the AIFMD that is balanced and appropriate, since it takes the specific conditions of private equity into account.

3. Responses to the specific questions in the Consultation

a) Views on the proposed definitions of leverage.

According to the Consultation, leverage is one of the main drivers of risk related to equity investments in funds.

The Committee proposes the use of an accounting-based financial leverage measure, **defined as the ratio of total assets over total equity**. We note that some alternatives are envisaged, whereby national supervisors would have the

[6] Directive 2011/61 of 8 June 2011 on Alternative Investment Fund Managers.

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discretion to choose a more conservative leverage metric. Still, the definition of leverage in the Consultation seems too simplistic, in particular in comparison with the approach taken in European Union law (see below).

The AIFMD addresses potential risks to the stability of the financial system from investors' exposures to funds. Where necessary, competent authorities are provided with the power to limit the fund's leverage and we believe that this is a powerful tool for supervisors to possess.

Since private equity funds generally do not use any leverage at the fund level, this power is unlikely to be applied to private equity funds.

b) Views on options for incorporating leverage into the calculation of risk weighted assets.

The BCBS may wish to consider the approach to leverage in the EU AIFMD framework. According to this framework, leverage of an alternative investment fund is defined **as the ratio between its exposure and its net asset value**.[7] 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.

But not all exposures are taken into account: in the case of PE funds, exposure that exists at the level of the non-listed companies and issuers invested in by PE funds should *not* be included when calculating leverage, provided that the fund or the manager acting on its behalf "*does not have to bear potential losses beyond its investment in the respective company or issuer*".[8]

In addition to the definition provided in the AIFM Directive, we also note that the methods provided in the implementing measures[9] of the AIFMD to calculate the leverage are the results of market studies. Two methods (the gross method and the commitment method) are used. The gross method gives the overall exposure of the AIF whereas the commitment method gives insight in the hedging and netting techniques used by the manager.

Furthermore, the AIFMD exempts borrowing arrangements from the leverage calculation, provided these arrangements are temporary in nature and are fully covered by contractual capital commitments from investors in the AIF.

The definition and approach to leverage under the AIFMD respect the diversity of fund structures and are more granular than the approach in the Consultation,

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[7] Article 6 of Commission Delegated Regulation 231/2013 of 19 December 2012, supplementing Directive 2011/61 with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.

[8] Article 6(4) of Commission Delegated Regulation 231/2013.

[9] Articles 7 and 8 of Commission Delegated Regulation 231/2013.

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while ensuring that risks are adequately captured. Compared with the BCBS approach, the EU definition and calculation of leverage is less abstract and more market-based. The EU approach also takes into account the differences between open-ended and closed-ended structures (such as private equity).

In sum, the BCBS should recognize that an exposure at the level of the portfolio company does not automatically translate into an increased exposure of the fund. In this respect, the AIFMD is proportionate and a better reflection of the economic risks faced when investing in private equity funds, and the fact that such funds, pursuant to the underpinning legal agreements, do not have to bear potential losses beyond their investment in the portfolio companies. Investments by banks into investment funds should be given specific and precise treatment in the capital regime, and this treatment should differentiate according to the use of leverage. In that respect, Article 128 of the EU Capital Requirements Regulation (the CRR)[10] should also be considered by the BCBS: under the Standardised Approach, the CRR provides for a specific treatment of investment into funds and foresees distinct and higher risk-weighting for investment funds with a specific measure of leverage[11] (and a lower risk-weighting in other cases).

c) Views on the proposed policy framework.

We find that there are several (and in some respects fundamental) misunderstandings of the way investments, exposures and risks are measured and in the methodologies and risk-weighting applied:

> -The focus put on credit risk by the BCBS seems inappropriate to us; a Value-at-Risk risk would be more appropriate for the risk-weighting of investments in PE/VC funds;
>
> -Private equity fund commitments by *limited partners* and investments in underlying companies by *general partners* should not be confused;
>
> -The methodologies suggested in the Consultation lead to misleading results, since they do not factor in diversification and ignore the upside of well performing funds.

The Risk Measurement Guidelines precisely aim to reinforce the principle that in a Value-at-Risk approach unrealised net gains from some funds can compensate for (un)realised net losses from others. This is consistent with the way investors manage their overall portfolio of assets and liabilities, **i.e. on a fair value basis.** The Guidelines also aim to stress that diversification (particularly over vintage

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[10] Regulation 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms.

[11] Article 128 CRR.

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years) have a significant impact on the risk profile of the portfolio of funds held by an investor. We would like to see this approach to unrealised net gains reflected in the final approach of the BCBS.

In fact, an exclusive **focus on credit risk** in the BCBS approach is inappropriate when analyzing the risks of investments in PE/VC funds. An investment in PE/VC funds has debt and equity characteristics but both the standard credit and market models are difficult to apply to this asset class. PE/VC fund assets are illiquid, which means that the relevant risk analysis should not apply a risk market paradigm, but rather a Value-at-risk approach.

In that respect, we would argue that **the use of probability of default (PD) or loss given default (LGD) is inappropriate and would result in a misleading calculation of risks.** Aggregating just the PD or LGD figures for *individual* funds, even when factoring in diversification benefits resulting from correlations between individual funds defaulting, will produce overall risk weights for portfolios of funds that are excessive.

Diversified portfolios of funds are significantly less risky than every individual fund as the *upside* of well performing funds compensate for the losses from funds which do not return the entirety of commitments drawn, a situation which occurs very rarely.[12] We note here that the Basel Committee has long accepted that unrecognised and unrealised gains (or latent revaluation gains) on equity investments can act as a buffer against losses.[13]

We note also that the BCBS approach neglects an important aspect of the risk faced by banks when investing in PE/VC funds. Any approach should address both the value of the fund's investments in portfolio companies and the value of its undrawn commitments, its future management fees and the fund managers' value added.

In our opinion, the LTA does not provide a fair picture of the exposures of banks which have invested in private equity funds. The LTA requires banks to risk weight the underlying exposures of a fund **as if the exposures were directly held**, and ignores the fact that the fund structure will typically alter the risk/return profile significantly compared to direct investments.

Rather than require the use of the LTA, the BCBS could instead review information on private equity funds to decide **on an appropriate model and**

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[12] According to a survey among insurers, only €243 million, which equates to less than 1% of current capital committed by respondents to private equity funds, has ever been lost from fully realized funds. This net loss was vastly offset by performance across the entire portfolio of funds. This survey was not conducted with banks; however, banks, like insurers, are subject to the same legal obligations and return profile.

[13] BCBS, Working Paper on Risk Sensitive Approaches for Equity Exposures in the Banking Book for IRB Banks, August 2001, p. 6.

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methodology for evaluating the risks of particular funds. Such methodologies may rely on the assessment of the volatility of net asset values (NAVs) or that of cash flows. The models may integrate factors such as undrawn commitments, the remaining life of the partnerships, the maturity of the portfolio, or future management fees.[14] More flexibility should be provided, not only between the various approaches used, but also in the measure of the value at risk.

We are also concerned with the treatment of investments by banks into funds-of-funds. The BCBS approach does not reflect the particular case of fund-of-funds -which compared with other funds offer greater diversification- but would be potentially subject to the risk weighting under the FBA (i.e. 1250%).

In addition to these remarks on the methodologies proposed in the Consultation, we would like to stress that the objective of the BCBS consultative process, which is to ensure an appropriately risk sensitive and consistently applied regulatory capital standard, would not be reached with respect to banks' investments in private equity funds.

In that respect, we would refer the BCBS to the "use test" requirement, which suggests that methodologies used to determine regulatory capital charges for particular business lines must also "play an essential role" in how banks measure and manage risk in that business.[15] We believe that the approaches proposed in the Consultation, in particular the LTA, would not fulfill the "use test" requirement with respect to bank investments in private equity.

Since, for investment in private equity funds, the proposed approach in the Consultation paper would not ensure an adequate assessment of risks, it would be solely used for regulatory capital purposes. We do not believe that the BCBS intends such a result.

4. Conclusion

In sum, the industry believes that if the Consultation were implemented as proposed, banks investments in private equity could potentially (i) face a significantly increased regulatory burden, and (ii)be subject to poorly calibrated regulatory capital requirements that do not reflect the actual risk of these investments as a result of a failure to take into account the actual risk profile of private equity fund investments, including with respect to the aggregate upside of such investments and the diversification of risks.

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[14] See Section 4 of the EVCA Risk Measurement Guidelines.

[15] Cf. for instance BCBS, The IRB Use Test: Background and Implementation, 2006.

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In response , banks may either opt for direct investment in companies, which may present additional risk management challenges to banks, or alternatively, rely on the default approaches (rather than the LTA), which are less risk-sensitive and automatically result in significantly higher capital requirements for banks, without any corresponding regulatory benefit.

Therefore, we would like to see the BCBS's approach to the capital treatment of investments into PE/VC funds better take the specificities of these investments into account. We believe that this would contribute to better risk management practices in the banking sector. The sole objective of prudential requirements should be to aim at *measuring* risks more accurately, on the basis of risk measurement tools that will then allow banks, in a second stage, to *manage* the various risks faced, in light of their overall portfolio.

EVCA would be keen to engage further the BCBS in order to further explain the views of the industry.

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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 700 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.