Submission

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

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

13th November, 2012

To: European Commission, Internal Market and Services DG,
Unit H.1 – Banks and Financial Conglomerates

Re: **Response to the Consultation on the recommendations of the High-level Expert Group on Reforming the structure of the EU banking sector**

Table of Contents

Table of Contents....1
Concerns and recommendations in regards to the reference and treatment of the private equity industry....2
Appendix: Key characteristics of the private equity industry....5
Appendix 1: Private equity and venture capital funds....5
Appendix 2: Investments by private equity and venture capital funds....6
Appendix 3: Private equity and venture capital risk....6
Appendix 4: The role of private equity and venture capital in the real economy....8

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.

Submission

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

Concerns and recommendations in regards to the reference and treatment of the private equity industry

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

2. The EVCA welcomes the Liikanen Report ("the Report") released on 2 October 2012 and its objectives of financial stability, efficiency and consumer protection. However, the PE/VC industry is concerned with some aspects of the recommendations in this Report. The main concern is that on the one hand the Report puts private equity clearly into the trading entity, yet on the other hand describes various activities which fully encompass what private equity actually does and places these in the deposit-taking entity.

3. In addition, the Report makes a number of references to "private equity investments" or "private equity like investments" without clarifying what is meant by either. As a consequence the Report is unclear in its recommendations for the treatment of PE activities. Our comments, requests and recommendations therefore, concern the reference of "private equity investments" and "private equity like investments" and their subsequent and potential treatment if the Report's recommendations were to be implemented.

4. The most relevant excerpts of the Report referring to private equity are the following:

   "*Any loans, loan commitments or unsecured credit exposures to hedge funds (including prime brokerage for hedge funds), SIVs and other such entities of comparable nature, as well as private equity investments, should also be assigned to the trading entity.*"

   "All other banking business except that named above, would be permitted to remain in the entity which uses insured deposits as a source of funding (henceforth "deposit bank"), unless firm-specific recovery and resolution plans require otherwise. These permitted activities include, but need not be limited to, lending to large as well as small and medium-sized companies; trade finance; consumer lending; mortgage lending; interbank lending; participation in loan syndications; plain vanilla securitisation for funding purposes; private wealth management and asset management; and, exposures to regulated money market (UCITS) funds. The use of derivatives for own asset and liability management purposes, as well as sales and purchases of assets to manage the assets in the liquidity portfolio, would also be permitted for deposit banks."[1]

   "*In 2006 Lehman took a deliberate decision to embark on an aggressive growth strategy, and to take on greater risk by substantially increasing its leverage and building up large exposures in commercial real estate, leveraged lending, and private equity-like*

[1] Pages v and 101 of the Liikanen Report.

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

investments. These undertakings were far riskier than many of its traditional lines of business, because instead of simply brokering transactions, the firm would retain substantial amounts of risk on its balance sheet. These risks were financed largely by short-term repurchase agreements, often totalling hundreds of billions of dollars per day."[2]

5. When banks become involved in private equity, they do so in one or more of the following ways:

- investing their own capital in private equity funds, or directly into unlisted companies;
- providing the debt component of mergers and acquisitions led by private equity funds;
- lending to private equity-backed companies; or
- managing capital on behalf of clients to invest in private equity funds.

Each of these activities would appear to be defined in the Report as activities which would be permitted to remain in the deposit bank entity. The table below details the private equity investment activity matched with the corresponding activity permitted in the Report's recommendations to remain in the deposit bank.[3]

Private Equity Investment Activity	Corresponding Activity Permitted to Remain in Deposit Bank
Investments by banks into private equity funds	Asset management
Providing the debt component of private equity fund sponsored M&A activity	Lending to large as well as small and medium-sized companies, participation in loan syndications
Lending to private equity backed companies	Lending to large as well as small and medium-sized companies, participation in loan syndications
Banks managing capital on behalf of clients to invest in private equity funds	Asset management

Any inclusion of the private equity activity detailed in the above table in the trading entity would not only be discriminatory, it could also have a detrimental effect on the financing of the real economy. EVCA, therefore, recommends and requests that the reference to "private equity investments" is deleted from the activities assigned to the trading activity as described in the first excerpt.

---

2 Page 60 of the Liikanen Report. This extract is found under the section relating to case studies, with the illustration of business models that failed in the crisis (under the sub-section on Lehman Brothers).

3 Pages v and 101 of the Liikanen Report.

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

6. The third excerpt mentions "*private equity-like investments*" without providing any information on the characteristics of such investments. Private equity-like investments often refer to funds which use similar fund structure to private equity funds, for example hedge funds or credit opportunity funds structured as limited partnerships. This does not mean they are in anyway similar to private equity funds which typically adopt an active ownership approach in making long term investments into unlisted, private companies.

   The EVCA also rejects the implication that investments in private equity funds or lending to private equity backed companies was material or causal in the collapse of Lehman Brothers.

7. The EVCA would also contend that it would be inaccurate and inappropriate to classify private equity as such "higher risk activities" and to assign them to the trading entity. PE does not contribute to systemic risk.[4] In addition, empirical evidence demonstrates that lending to PE backed companies or providing the debt component of PE M&A activity is no more risky than any other form of corporate lending. In fact, statistics show that default rates of the companies backed by PE/VC funds are lower than non-private equity backed companies and upon default PE backed firms do not have lower lender recoveries compared with debt in non-private equity backed companies In addition private equity backed companies in Europe typically have a much larger equity component on the balance sheet than non-private equity backed companies. The average equity component of private equity backed companies has increased significantly since 2007.[5]

8. We also note that "venture capital firms" are referenced in CRD IV / CRR as "*exposures with particularly high risk*" without a definition of a "venture capital firm" [6]. In addition, there has been a general reference to "*private equity investments*" in the context of the discussions on CRD IV. We also note that certain Alternative Investment Funds, which could include private equity funds, are also included in this category, both in the Presidency compromises and in the text as discussed by the European Parliament. There is no justification as to why "venture capital firms" or the Alternative Investment Funds detailed are included in this "high risk exposure category".

9. Given the information detailed previously in points two to eight, supported by information supplied in the Appendix of this document the EVCA requests the commission:

   - **Recognises that is inappropriate in the Report to detail "private equity investments" in the activities assigned to the trading entity,**
   - **Makes a clear distinction between "private equity investments" and "private equity-like investments",**
   - **Clarifies and defines references to "venture capital firms" in CRR IV,**
   - **Recognises that it is inappropriate in the context of this Report and in CRR IV to classify private equity funds and venture capital funds/firms as a "high risk exposure".**

---

4 De Larosière Report (February 2009).

5 See evidence detailed in Appendix 3: Private Equity and Venture Capital Risk

6 See Article 123 of the Proposal for a Regulation on prudential requirements for credit institutions and investment firms, COM (2011) 452 final, 20.7.2011.

Submission

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

Appendix: Key characteristics of the private equity industry

Appendix 1: Private equity and venture capital funds

Private equity funds evolved over time from individual investments into unlisted companies being undertaken by institutional investors to funds which pool the interests of multiple investors in a common vehicle. By pooling capital investors diversify risk and benefit from the specialist investment skill of an independent manager. Private equity and venture capital funds are often, but not always, structured as limited partnerships with a contractual limited life, usually of ten years. The investors become limited partners in the partnership and their liability is limited to the capital committed to the fund. The fund is managed by the general partner which has unlimited liability.

Private equity investment, i.e. an investment of the kind that is generally undertaken by private equity and venture capital funds, is typically investment in unlisted, private companies. As such each acquisition and sales process is different, however all private equity and venture capital funds share the following characteristics:

- PE funds typically make long-term, one hundred per cent equity backed, investments,
- PE funds do not offer redemption rights for investors,
- PE funds do not use leverage at fund level, i.e. they are not exposed at fund level,
- PE funds do not engage in credit origination activities.

Against the background of these characteristics of private equity and venture capital funds a fund structure has developed that may be defined as follows:

> *"Private equity and venture capital funds are unleveraged funds which predominantly invest in equity instruments and instruments that are economically similar to equity instruments issued by unlisted companies.*
>
> *Such funds are characterised by alignment of interest through sharing of risk between management and investors. They are generally only open to eligible investors, namely professional clients and certain sophisticated HNWIs, and do not provide redemption rights to investors for a period of at least five years after the first closing of the fund, i.e. the date when the first investor is admitted to the fund.*
>
> *Private equity and venture capital funds of funds invest in private equity and venture capital funds as defined above."*

From 2007 to 2011 Banks accounted for 14% of all investment into European private equity funds[7], however, typically, no more than 0.5% to 2.0% of the overall balance sheet of a bank is invested

[7] EVCA/PEREP_Analytics (2011)

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

into private equity funds. In addition the aggregate amount lent to Private Equity backed companies represents only a small percentage of the European banks' assets[8].

Appendix 2: Investments by private equity and venture capital funds

When acquiring a company, PE funds, typically use a double-layer structure by investing in a holding company which then in turn acquires the share in the operating portfolio company. The investment in the holding company is equity backed. When debt is employed, at the level of the portfolio company, or its holding company, each portfolio company/holding company only carries its own debt, without any subsequent exposure of the fund.[9] The debt is collateralized with the assets of the respective portfolio company and the shares are held by the fund in the acquisition company - this is no different to the practice employed in everyday business for companies to raise capital through bank loans. There is no cross-collateralisation between the assets of different portfolio companies held by the PE fund for the debt of other portfolio companies. This means that even in case of a default investment, there is no impact on the other investments of the PE fund.

The contribution of additional resources by the private equity fund manager in the form of board and management capacity, access to networks, corporate development expertise and knowledge of financial markets is known as active ownership. This typically means the GP taking an active role on the board of portfolio companies, and in many cases using networks to appoint board members, while also helping develop and execute business strategy, including preparing the business for eventual sale or IPO.

PE/VC funds are also long-term oriented in their activities and their investment: the average holding of the portfolio companies by such funds is more than 5 years. In contrast, the average holding time of an institutionally held quoted share in Europe is one year or less.[10]

Appendix 3: Private equity and venture capital risk

Many studies have shown evidence that investments by institutional investors in a diversified portfolio of private equity funds have a relatively low risk. One of the most important studies in this area from Weidig / Mathonet (2004) shows that a portfolio with more than 20 funds has extremely limited risks (i.e. zero risk) with a confidence level of 99% of losing any capital over the entire lifetime of the portfolio[11].

The default rate of private equity backed companies was only 2.8%, compared to 6.2% for other companies during the recession of 2008-2009.[12]

Private equity-owned companies that default are less likely to be liquidated and they remain in bankruptcy for a shorter time. According to various studies,[13] approximately 11% of private equity-

---

8 The ECB estimates this share to be less than 1%. Cf. European Central Bank, Monthly Bulletin, Leveraged Buyouts and Financial Stability, August 2007, p 89-98.

9 See Recital 78 of Directive 2011/61 of 8 June 2011 on Alternative Investment Fund Managers, OJ L 174/2011, 1.7.2011.

10 EVCA/PEREP_Analytics (2011) and Strömberg (2009)

11 Weidig and Mathonet (2004), "*The risk profiles of private equity*".

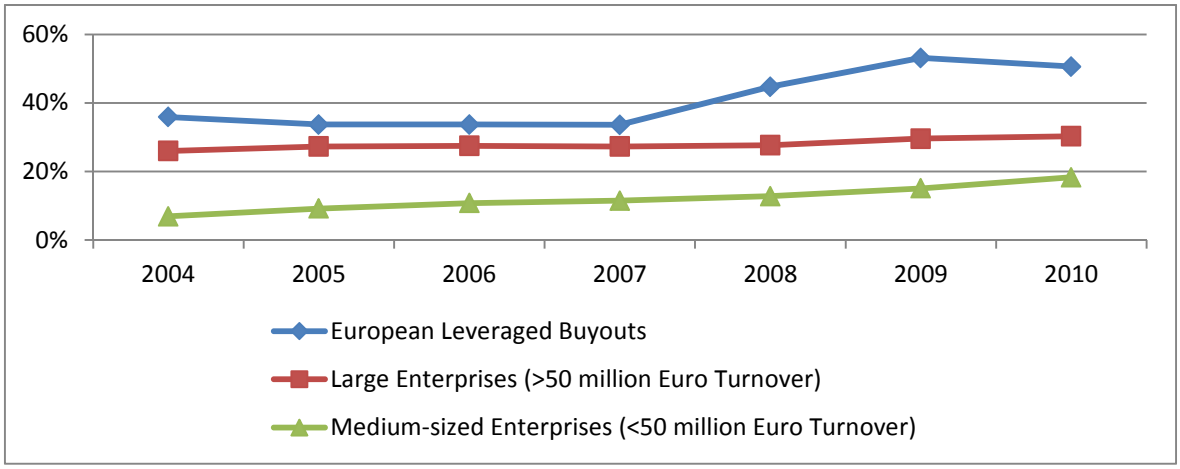
12 Rf. Thomas, J. M. (2010) "*The Credit Performance of Private Equity-Backed Companies in the 'Great Recession' of 2008-2009*" . Available at SSRN: http://ssrn.com/abstract=1582666.

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

owned companies that declared bankruptcy were liquidated, compared with 16% for those without private equity backing. In addition private equity backed companies that do default do not have lower lender recoveries compared with debt in non-private equity backed companies which default[14].

Private equity backed companies in Europe typically have a much larger equity component on the balance sheet than non-private equity backed companies. In addition the average equity component of private equity backed companies has increased significantly since 2007. The graph below illustrates the equity ratio in private equity companies compared to medium and large enterprises in Germany.

Comparison of Equity Ratio (%) between German Enterprises and European Leveraged Buyouts



Source of Analysis: BVK
Data Sources: LBO data by S&P LCD, German Enterprise Data by DSGV Diagnose Mittelstand

The PE industry provides stability and does not contribute to systemic risk or pro-cyclicality. As recognised by the De Larosière Report[15] and by the Turner Review,[16] private equity did not play a role in the 2008 financial crisis. This has also been acknowledged by the Alternative Investment Fund Managers Directive (AIFMD), which includes specific provisions in relation to the private equity industry, on the basis of its specific characteristics.[17]

---

13 See Strömberg, Hotchkiss and Smith (2011), "*Private Equity and the Resolution of Financial Distress*", ECGI - Finance Working Paper No 331/2012. The data covers the 1997-2012 period. See also Kaplan and Strömberg (2008), "*Leveraged Buyouts and Private Equity*".

14 Moody's Investor Service Newsletter (June 2012).

15 De Larosière Report (February 2009), p. 24.

16 The Turner Review, "*A regulatory response to the global banking crisis*" (March 2009), p. 72.

17 Cf. Recitals 34 and 78 of Directive 2011/61 of 8 June 2011 on Alternative Investment Fund Managers, OJ L 174/2011, 1.7.2011.

Submission

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

Appendix 4: The role of private equity and venture capital in the real economy

As evidenced in various reports and studies by the European Commission and the European Central bank,[18] one of the key issues and most pressing needs for European SMEs today is access to finance.

There are approximately 23 million SMEs in the European Union, some 21,000 of which are held through funds managed by over 1,900 private equity and venture capital firms.

83% of all PE fund investments are in SMEs. 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 in the EU. As dynamic enterprises, they are significant contributors to innovation and breakthrough technologies.

A recent study[19] shows that, on average, private equity-backed SMEs had an annual growth rate of 7% over a four year period. For European SMEs, the average growth rate is around 2%.

For more information on the economic impact of private equity and venture capital activity in Europe please visit http://evca.eu/facts/

---

[18] 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 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).

[19] 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).