THE VOICE OF
PRIVATE CAPITAL
VENTURE CAPITAL
PRIVATE EQUITY
INFRASTRUCTURE
LONG TERM INVESTORS

8 November 2019

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

Response to the European Commission's Targeted Consultation Document on "Alternative standardised approach for market risk"

Introduction

Private equity[1] funds typically make long-term, equity-backed investments in businesses. As such, they play an important role in delivering the economic growth that creates jobs and enhances the long-term competitiveness of the European Union. Private equity funds are, usually unlisted, alternative investment funds (AIFs) managed by specialist fund managers and are typically offered to a wide investor base including institutional investors such as banks, insurance companies and pension funds.

These funds provide long-term financing for more than 5,000 European businesses each year, 86% of whom are SMEs, employing around 8 million people. They connect providers of capital from across the EU and beyond with businesses that are looking not only for equity investment, but also for the operational guidance and assistance that a private equity manager can bring. It is this combination of the provision of long-term capital and active management, known as patient capital, that characterizes the private equity model. Investments in unlisted companies made by private equity funds are held for an average of six years, enabling private equity to help support and develop successful, sustainable companies. This makes private equity funds an attractive investment opportunity for banks looking for real returns and to meet some of their long-term liabilities.

The relationship between private equity funds and banks, and the ability of banks to commit capital to this type of fund are heavily influenced by the capital requirements set in the Capital Requirements Regulation (CRR) that apply to banks' investments in collective investment undertakings (CIUs).

We welcome the explicit clarification made concerning the assignment to the non-trading book of positions in CIUs in cases where such positions are not relevant for the purposes of calculating the own funds requirements of those positions. However, we would like to comment on one aspect of the consultation document regarding the treatment of market risk, as set out in the conditions for the use of the mandate-based approach, as we believe the proposed terminology "daily price quotes" is one that requires further clarification for unlisted funds.

We stand at the disposal of the European Commission should it need any additional information on the impact of capital requirements on the bank/private equity relationship. We will also provide a response to the recently launched consultation on the transposition of the Basel III framework into EU law – particularly regarding the Section on "Equity and other capital instruments". We will use this opportunity to reiterate the industry's concerns with the look-through approach (which fails to take into account the diversification benefits of investing into a fund) and with the reference to "investments in private equity" and "investments in venture capital firms', which creates unnecessary confusion.

---

[1] The term private equity refers to both private equity and venture capital. Where there are specific characteristics relating to the venture capital industry only, we use the term venture capital.

Approaches for equity investments in CIUs that do not qualify for the look-through approach

Q5. How frequently would you expect to use the mandate-based approach?

Credit institutions will not always be in a position to use the look-through approach for their investments in private equity. In those cases, and provided the bank has the objective to include the exposure as part of the trading book, we see a difficulty with the wording of Article 325j (b), as currently proposed by the European Commission, in relation to investment in CIUs **that are themselves unlisted entities**. Whilst banks will have no difficulty at all in complying with the requirement of Article 325j (b) in terms of having knowledge of the content of the mandate of such CIUs, the difficulty arises in meeting the second requirement that "…daily price quotes for the CIU can be obtained,…".

The private equity funds in which banks invest, alongside other institutional investors such as insurance companies and pension funds, are typically unlisted CIUs. Consequently, "price quotes" for these CIUs, in the sense that is used throughout the Regulation in the context of investment in listed equities (whether directly or indirectly through CIUs), simply do not exist (daily or otherwise). What does exist for these unlisted CIUs are quarterly Net Asset Values (NAVs).

It is a very long-standing practice that institutional investors in private equity funds use the NAVs of the funds in their private equity fund portfolios as the basis for a proxy for the prevailing "market value" of the funds in which they are invested. For example, if an institutional investor in private equity funds, such as a bank, is required as part of its broader internal reporting or compliance purposes, to identify a "daily value" for its private equity portfolio (alongside all the other assets in which it invests) then the normal process is to base the "daily proxy NAV" on the NAV of each underlying fund - as at the end of the previous quarter - and add on any cash flows to or from the fund since then (as a reminder, in a private equity fund, commitments are made and drawn down over time and distributions are made as they arise).

In order to avoid inadvertently disincentivising investment in unlisted equities simply because the CIUs through which banks invest to obtain exposure to such equities are themselves unlisted entities, the industry-wide method, typically used by institutional investors who need to identify such proxies, could easily be referenced by making the following change to Recital 5:

*"[…] Institutions should therefore be allowed to use other approaches, provided they are aware of the content of the mandate of the CIU and can obtain daily price quotes. **For unlisted CIUs, these quotes may be based on the CIU fund manager's most recent quarterly net asset value**. […]"*

If no clarity is brought in the text, there is a serious risk of an unintended consequence, namely that investments in unlisted CIUs, that ultimately invest in unlisted companies, will be curtailed, with the two following implications: an impact on the ability of banks to support innovative and growing businesses through private equity, and in particular venture capital, funds; and the creation of an unlevel playing field between investments in listed and unlisted companies at the detriment of some of the objectives of the Capital Markets Union.

Q7. Do you have any comments regarding the 'single equity' approach?

While we understand the rationale behind the inclusion of the single equity position in the "other sector", we would like to point out that a private equity fund investing in advanced economy companies is not, in practice, a riskier investment than an investment in a listed entity in an emerging market. This is again demonstrating the broader issue with the treatment of unlisted equity through funds under the market risk approach.

Contact

For further information, please contact Christophe Verboomen (christophe.verboomen@investeurope.eu) at Invest Europe.

About the PAE

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

About Invest Europe

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

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

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

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

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

For more information please visit www.investeurope.eu.