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LONG TERM INVESTORS

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

Response to European Commission Consultation on implementing the final Basel III reforms in the EU

I. Equity and other capital instruments

a) <u>Standard treatment of equity exposures</u>

Question 20. In your view, are there any issues with the definition of equity exposures provided by the Basel III standards (paragraph 49) and the list of other instruments to be treated alike?

In particular, would you deem further refinements or clarifications necessary regarding the scope of the equity exposure class in order to ensure a consistent application across the Union?

Please elaborate.

Our understanding is that when a credit institution commits capital to a private equity or a venture capital fund, such commitment will be classified under Article 132 CRR (investments in collective investment undertakings). However, under the existing CRR approach, credit institutions will still have to calculate its exposure to a collective investment undertaking (CIU) by multiplying the risk-weighted exposure amount of such CIU's underlying exposures. This means that Article 133 (equity exposures) and Article 128 (high risk exposures, including "investments in private equity" and "investments in venture capital firms") will be relevant to determine the ultimate risk weight of a bank's investment in an equity fund.

From a technical point of view, we note that the proposed definition of "equities" may not accurately reflect the specificities of equities held in funds, and more specifically, equities held within closed-ended funds, i.e. private equity and venture capital funds. Contrary to other equity investments in commercial enterprises, where it is at the discretion of the investee enterprise whether or not profits are paid out, it is inherent to closed-ended funds that the investments are sold at one point in time and the excess proceeds distributed to the investors. While the capital cannot be redeemed, the investment amounts will be returned to the investor "automatically" in the ordinary course of the business of the fund. Further, there is an obligation on the "issuer" to liquidate after the fixed term has expired.

More generally, the existing CRR approach, which is based on a look-through approach vis a vis the underlying equity, does not adequately take account of how the exposure to equity is achieved when it is made through (closed-ended) funds and the impact this has on the "risk" of the exposure. There is indeed a considerable risk benefit achieved as a result of gaining exposure to unlisted equities via a diversified portfolio of unlisted companies -and, from a broader perspective, towards a diversified portfolio of funds - which CRR disregards.

This means that banks gaining exposure to unlisted companies in a risk-adjusted fashion via funds will find themselves faced with unjustifiably large risk-weights for those investments. Coupled with the unjustified treatment of exposures to private equity and venture capital-backed companies as "highly risky", this disincentivises banks' investments in private equity funds, at a risk of preventing them to channel funding to SMEs[1] through these diversified vehicles despite the obvious benefits which these investments could represent for the banks and for the SMEs.

Question 21. Views are sought on the costs and benefits of the revised standard treatment for equity exposures under Basel III (paragraph 49-50).

In particular, would you consider any further differentiation among equity exposures (apart from "speculative unlisted equity exposures" and "national legislated programmes" - see 1.1.4.2. and 1.1.4.3.) warranted?

We do not believe that there is any reason to distinguish between types of equity exposures on any basis other than the actual level of risk borne by such exposures.

As we explain in our responses to questions below (23 and 24), we believe that the definition of high risk exposures needs to be circumscribed to those exposures, as defined in Section 4.2 of relevant EBA Guidelines, that "exhibit levels and ranges of risk drivers that are not common to other obligors" or "transactions of the same exposure class the actual cases where the equity bears a high risk". It should in any case exclude any exposures of the banks through closed-ended and unleveraged funds.

We find the current approach, which considers certain parts of the market as highly risky for the simple reason that exposures are not listed on an exchange or meet certain characteristics which are not directly connected to their level of risk, to be inappropriate and not backed by clear evidence, as we demonstrate in our response to Question 23.

b) <u>Treatment of 'speculative unlisted equity exposures'</u>

Question 23. Do you agree that speculative unlisted equity exposures such as investments in private equity or venture capital firms should be subject to a relatively higher RW than other equity exposures?

We are not opposed to the principle that some types of exposures, when they are deemed speculative, should be subject to a higher risk weight; however, we fundamentally disagree with the notion that "investments in private equity" or "investments in venture capital firms" should *de facto* be considered as "speculative unlisted equity exposures". This is especially true as "high risk exposures" will be subject to a very substantial increase, from 150% to 400%, which will severely impact banks' abilities to commit capital into equities.

Our understanding from previous European Commission Q&As (in particular Q&A 2013_374) on the Capital Requirements Regulation (CRR) and the recent EBA Guidelines on high risk exposures[2] is that "investments

[1] According to Invest Europe data, 99% of the companies that received funding from venture capital in 2018 were SMEs (86% for the entire private equity asset class) (Invest Europe/PEREP, 2018 European Private Equity Activity).

[2] Guidelines on specification of types of exposures to be associated with high risk under Article 128(3) of Regulation (EU) No 575/2013, 17 January 2019

in venture capital firms" and "investments in private equity" means banks' direct investments into unlisted companies.

Exposure to unlisted companies through a portfolio of private equity and venture capital **funds** has a completely different risk profile from direct investment in unlisted companies. However, as recognised by the European Commission in its Q&As, the treatment of "investments in venture capital firms" and "investments in private equity" as high risk exposures has an impact on the risk-weight that is applied to the private equity fund. This is because the use of the "look-through approach", as proposed in Article 132 and 132a of the CRR, creates a situation where the risk-weight of a private equity or a venture capital fund is determined by the combined exposures of the underlying investment of such funds. As a private equity fund typically invests in companies which the regulation defines as "investments in private equity" (and similarly venture capital funds invest in companies that are defined as "investments in venture capital firms"), it is the whole fund that ultimately risks being treated as a "high risk exposure" due to the look-through approach.

The ultimate risk weight that is applied to banks' exposures to those investments is an issue as the creation of a private equity/venture capital fund portfolio is a long-term, strategic endeavour and the total antithesis from short-term, speculative, trading. As a reminder, the private equity and venture capital funds in which banks invest are typically structured as 10-year closed-end vehicles with no ability to redeem the holding in the fund before the end of its lifetime. The companies in which the funds themselves invest are typically held for an average of six years and funds typically invest in around 15-25 companies (often more for venture funds), thereby diversifying the risk born by exposures to any single company within the fund.

Once an underlying investment is sold, the proceeds are distributed back to the funds' investors. The funds in which banks invest are not themselves invested in for the purpose of short-term resale, nor are the underlying companies in which the funds invest. Consequently, to treat them as if they were, or even in the same way as if the unlisted companies were invested in directly by the banks, reflects a fundamental misunderstanding of the risks involved in two very different types of investment activity.

While we cannot comment on the risk of banks' direct investments into unlisted companies, other than to note that direct exposure to unlisted companies is inherently more risky than exposure through a diversified portfolio of funds, we have two concerns with the current inclusion of "investments in private equity" and "investments in venture capital firms":

a) **a terminology concern**: we do not believe that it is appropriate to refer to banks' direct investments into unlisted companies as "investments in private equity" and "investments in venture capital firms"
b) **a concern with the prudential approach**: we do not believe that it is appropriate to consider the indirect exposure a bank has to a company backed by a private equity fund as "highly risky" for the sole reason it has certain characteristics (as defined in paragraphs 1 and 2 of the EBA Guidelines on high risk exposures) unrelated to its risk profile

Concern with the terminology

As we explained in the paragraphs above, the existing wording of Article 128 CRR, which covers banks' direct investments in unlisted companies, does not reflect the reality of how exposure to unlisted companies is normally gained when banks seek to invest in unlisted companies. From an industry perspective, a venture capital or a private equity investment typically means, for investors and fund managers alike, an investment in a venture capital or a private equity **fund.**

Given these investments are covered, for the purpose of the standardised approach, under Article 132 CRR, the proposed terminology creates confusion for credit institutions. This confusion is only partially addressed by the clarification introduced in the Guidelines (as the definition presented in the Guidelines, while explicitly excluding investment in funds, describes the types of investments such funds would make). Moreover, it is further increased by the use of the term “firms” at the end of “venture capital” – as a “venture capital firm” is technically the manager of the venture capital fund.

We would therefore strongly suggest a removing any reference to “investments in private equity” and “investments in venture capital firms” in the wording of Article 128 CRR or, or at the very least, replace it with more accurate wording. For example, the use of “direct investments in unlisted equity” may be more appropriate in that context.

<u>Concern with the prudential approach</u>

Further to our concerns with the terminology, we do not believe there to be an economic rationale for considering unlisted equity investments as “high risk” if they are not deemed “speculative” under paragraph 5 or 6 of the EBA Guidelines on high risk exposures.

This is especially true as such a treatment will – as explained in the introduction of this response - mostly have an impact - due to the look-through approach - on banks’ ability to invest in private equity and venture capital funds, which remain the main channel for banks to gain exposure to these unlisted companies.

From the private equity and venture capital funds’ perspective, giving a 400% risk weight to banks’ indirect exposures to unlisted companies is inappropriate for the following reasons:

i) it fails to take into account that fund diversification reduces the overall risk of the investors’ exposure;
ii) at the portfolio company level, it underestimates, in a Capital Markets Union context, the ultimate value of private equity, and more specifically venture capital investments;
iii) at the portfolio company level, it overestimates the risk of failure of private equity-backed companies (compared to, for example, listed companies)

Benefits of diversification

CRR has so far given very little consideration to the substantial risk-mitigating benefits of diversification in the private equity context[3]. Since a typical institutional investor in private equity (including bank investors) invests in dozens of private equity funds, with each fund in turn holding over a dozen portfolio companies, a typical institutional private equity fund portfolio will have exposure to several hundred unlisted companies. These companies will be diversified across funds managed by a large number of different fund managers. The companies will have been acquired at different stages of the economic cycle, in various geographies, in a range of sectors and at different stages of their development, from small, through medium, to some very large companies.

For any given diversified portfolio of funds, it can be demonstrated that the significant upside from underlying companies that perform well more than compensates for the losses arising from any underlying companies that do not return some, or even all, of the original capital invested in them. Academic studies

[3] For the purpose of this section, we refer to private equity as the entire asset class, including venture capital.

and practitioners have consistently shown that diversification across several private equity funds and over several years is the most important market risk reduction mechanism in private equity (see for example, BVCA Risk Report, 2015) and it is therefore problematic that this has long been ignored by the CRR framework.

Solely from an Article 128 perspective, even within a single private equity fund, the diversification through investment in a number of portfolio companies ensures that the fund is well-placed to generate a positive return for investors even if an investment in an individual portfolio company yields a loss (see below for details on the typical return and risk of a portfolio company investment). The large degree of diversification, which substantially mitigates the risk associated with any single company held within any single fund, reduces the risk for bank investments gaining exposure to unlisted companies through private equity and venture capital funds, and should therefore be reflected in any approach for determining regulatory capital requirements for such investments.

Benefits of private equity and venture capital

Over the past few years, the European Commission has made significant efforts to promote investments in SMEs, and more specifically in innovative and growing SMEs, recognising the long-term economic and social benefit of supporting these companies.

While a single direct investment into an innovative SME is naturally risky (although, as explained above, this is not generally how institutional investors gain exposure to such companies), it is also more likely to have a substantial benefit as it may ultimately lead to the creation of new products and market segments that will increase the growth of the European economy. If banks were more able to invest in such companies, they themselves may come to experience the benefits of futureproofing their own business with new products and services rather than to be overtaken and left behind by the newcomers.

We believe that it is important for the prudential assessment, while relying firstly and foremost on the risk of the investment, to also include considerations of the impact that the value of such investments can have on the vitality of an economy. Venture and growth capital are themselves widely seen as a unique way to support high growth companies and it is surprising that the European Commission, which has spent so much time on ensuring the development of this industry as part of the Capital Market Union, has so far taken little focus on ensuring that banks are not disincentivised from committing capital into these industries.

The current situation is alarming. According to Invest Europe data[4], banks represented until 2009 around 12% of the overall investment in venture capital – over the past few years, that number was down on average to 5%. This is significantly less in proportion, for instance, than what family offices and private individuals are investing into the industry (around 20%) – despite the fact that the total amount of assets held by banks largely dwarfs these categories. It is telling for example that in 2018 banks invested into venture capital only as much as academic foundations and endowments did. This in turn represents a serious deficit of capital that could fund transition to a more efficient, healthier and more carbon neutral economy, all challenges that could ultimately weigh down on the viability of other assets.

In that context, increasing the risk weight for “investments in private equity” and “investment in venture capital firms” from 150% to 400% is something that is incomprehensible and not in line with the proposed objectives of the Capital Markets Union. We would therefore call on the European Commission to consider

[4] European Private Equity Activity Report and Data 2018

not taking action that would make investments in venture capital and private equity funds, and ultimately in underlying businesses backed by venture capital and private equity, even less attractive to banks.

Private equity and risk

Finally, and perhaps most importantly, we believe that there has not been any clear economic rationale, either from the Basel committee or from the EBA, as to why there should be an increase of the risk weight for investments in private equity from 150% to 400% (other than the fact these are *de facto* considered as high-risk exposures). Moreover, it is a common misconception that private equity backed companies are highly risky investments.

Both BVCA's *Performance Measurement Survey* (for the UK market) and France Invest's *Performance nette des acteurs fraçais du capital investissement* (for the French market) show how the private equity asset class has outperformed other market players over the past few years. There is also academic evidence that supports the view 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 model based on credit risk only assumes a maximum return of 1x. However, the majority of private equity fund returns are between 1x and 3x capital. The CRR framework does not take this distribution of returns into account, with the potential result being inadequately calibrated capital requirements which do not reflect the actual risks that banks investing in a private equity or a venture capital fund are facing.

Moreover, a number of studies have demonstrated that the default rate for private equity-backed companies is actually lower than for comparable publicly-owned companies[5]. Private equity-backed companies also generally have a better corporate recovery and survival rate[6]. There is also significant evidence that the average default rate for private equity portfolio companies is effectively lower than the average default rate for non-private equity-backed borrowers - in Europe, the default rate is up to 25% lower than for non-private equity backed companies[7]. Even in case of default, a recent Moody's review of failed private equity backed companies showed that the private equity ownership did not translate into substantially higher firm-level losses when comparing to non-private equity owned ones. While we do not believe that private equity-backed companies should receive a better treatment than other equity exposures, it equally makes little sense for them to be subject to a *less beneficial* treatment.

Finally, it is worth pointing out that inappropriate risk-weightings for investments in private equity and venture capital funds will necessarily result in an inefficient allocation of bank capital, which could ultimately mean that banks will be forced to be exposed to asset classes with less favourable risk-return profiles than private equity to achieve higher returns.

Conclusion

In light of the above, our industry has two fundamental issues with the current CRR approach:

a) with the terminology (the use of the terms "venture capital" and "private equity")

[5] 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.

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

[7] Kaplan and Strömberg (2009). This study was based on 3,200 businesses.

b) with the assessment of the actual risk of gaining exposure to unlisted companies when that is done by investing in a diversified portfolio of private equity and venture capital funds.

Regarding the former, we believe the proposed terms are inappropriate and should therefore be replaced. Not only are these terms no longer used (is the case for private equity) or inappropriately applied (as is the case for venture capital – see Question 24), in the Basel context, they also create confusion between direct investments in unlisted companies and investment in funds which in turn invest in unlisted companies. This is especially true as they could easily be replaced by wording that more accurately captures what is effectively a "speculative unlisted equity exposure" and which only refers to a credit institution's direct investment into a company.

The second, and perhaps more fundamental issue with the current approach is the characterisation of an investment in an unlisted company as "highly risky" when it is done through a private equity or venture capital fund. As we have shown above, there is little evidence that a company owned by a venture capital or a private equity fund is riskier than another unlisted company or even than a listed company *because* it is owned by a private equity or venture capital fund (which appears to be the overarching message since the publication of the EBA Guidelines on high risk exposures).

The very fact that the bank is only exposed to the company through a fund – with the diversification benefits that this type of investments entails –makes any investment *less risky* from the bank's perspective. A Europe Economics study commissioned by Invest Europe, looking at the risk of investing in venture capital and private equity funds for insurers and other type of institutional investors, as well as the research report Risk and Private equity prepared by the BVCA[8] all showed that diversification – at fund level but also at the bank level- does indeed play a major role in reducing risk.

In spite of this, the current CRR architecture and the use of the look-through approach in Article 132 ultimately creates a situation where any unlisted company that is part of a private equity fund's portfolio may be deemed highly risky, ultimately subjecting the bank's exposures to an entirely diversified private equity fund to a 400% risk weight that is uncorrelated to the actual risk of such exposure. We believe there is no valid reason for a bank's investment in a diversified fund's portfolio to result in a much higher risk weight as compared to the bank investing **directly** into the equity of a single (or even small portfolio of) listed companies.

We would therefore suggest to the European Commission that:

a) the only exposures subject to a higher risk weight should be direct holdings in those individual exposures that carry a high risk of loss "due to being structurally different from other obligors or transactions of the same exposure class"

These exposures are already clearly identified under paragraph 5 of the recent EBA Guidelines on high risk exposures. This approach would ensure that only those direct unlisted equity investments that are actually at risk of creating a greater loss for the credit institution would continue to fall into the high-risk bucket. This will not be less prudentially sound as it will also capture those unlisted companies owned directly by a bank, previously deemed "investments in private equity", when they meet those characteristics. This would also, in our opinion, correctly interpret the definition of what is a "speculative unlisted equity exposure" under the Basel framework.

[8] Risk in Private equity, BVCA, 2015

b) It should be clarified that, when exposure to the equity is through a closed-ended and unleveraged collective investment undertakings (CIUs), such an investment shall not be deemed a "high-risk exposure".

This approach would ensure that exposure to unlisted equities through closed-ended private equity funds, with no redemption right for the credit institution and with the diversification benefits we have highlighted above, would not be classified as "speculative" due to the fact banks' exposures are in this case made for the long-term.

It is worth pointing out that these changes would mirror the recent amendments made to the Solvency II Delegated Regulation, which recognise that, for investments in closed-ended and unleveraged funds, criteria to determine the ultimate risk-weight should be assessed at the level of the fund and not at the level of the portfolio company.

Question 24. Views are sought on the definition of 'speculative unlisted equity exposures' provided by the Basel III standards (paragraph 51 and footnote 31).

In particular, would you deem further refinements or clarifications necessary?

While we cannot comment on all aspects of this definition, we believe that the current definition of "speculative unlisted equity exposures" should be amended to remove the unhelpful reference to "venture capital".

- Using the term "venture capital" is ambiguous and creates confusion

The term "venture capital" is used as a short-hand to describe the segment of the unlisted (or "private") equity market that covers companies in the start-up or earlier stages of their existence (usually classified as seed/start-up, early and late stage venture). The sub-set of the fund management industry that is active in supporting businesses at these early stages are known as "venture capitalists" or "venture fund managers".

As we mentioned in our response to Question 23, the rather loose use of the term "venture capital" (in the Basel and CRR case) and "private equity" (in the CRR case) creates unhelpful confusion between a bank's direct investment into an unlisted company in the venture segment of the unlisted equity market– which may or may not be highly risky - and the situation where the bank gains exposure to such companies through venture capital funds – which are not highly risky in any case. While the concept of "venture capital investing" by institutional investors, including banks, most commonly refers to investing in venture capital funds, gaining exposure in this way has a very different risk profile to investing directly in unlisted companies.

Given that the objective of Article 128 CRR is to not cover investments in funds, the use of the term "venture", which is first and foremost made in such a context, is therefore perhaps not the most appropriate one to use in the Basel definition. We suggest that it would be better to make a clear distinction in the wording between the two types of investing, namely, direct investing and fund investing.

Further to the concern with the terminology, we believe that by its very nature "venture capital" investment, especially when the exposure is to a venture capital fund, is not at all speculative and does not fit with the types of investments intended to be covered by the rest of the proposed definition.

- Venture capital is not an investment comparable to those made for "short term resale purposes"

Far from being a short-term speculative investment, venture capital is characterized by the concept of patient capital: the combination of financial investment with active ownership of that investment, bringing business management experience to help the company grow and develop. It is this combination of the provision of long-term capital and active ownership that characterizes the private equity model. Investments in unlisted companies made by private equity funds are held for an average of six years (and even slightly longer in a venture capital context), enabling private equity to help support and develop successful, sustainable companies.

The long-term commitment made by the bank, through the fund manager, will ultimately contribute to the growth of the company to a stage where it can reach new markets and issue new products, as the money invested by the venture fund is used for product develop and capital investment in the business – the very opposite of an investment which only has the objective of a short term gain.

- Venture capital investments are not subject to price volatility

Banks' investments in venture capital (especially through venture funds) are not subject to price volatility in the way a directly held listed equity is, or even in the way listed companies held via a fund are. By definition, there is no market price for the shares in an unlisted company. They are illiquid investments made by a fund, which itself is illiquid, with no redemption rights during its typically 10 years, life-span (usually extended by at least one or two years). While this requires the bank to hold the assets for a defined period, the price of the assets is not volatile and not subject to market pressures. The interim net asset value ("NAV") will reflect the progress of each of the underlying companies in developing their technology or products, finding markets for their products and growing their market share – all of which only happen gradually over a number of years. As an investor, the bank is also unable to initiate the sale off an underlying company – this will also remain the prerogative of the fund manager.

- Venture capital is not about the anticipation of significant future capital gains

While it is true that investing in unlisted companies is fundamentally about investing to grow the business and generate long-term capital gain by helping the company grow and develop, it is a misconception that this implies highly speculative, high risk investing where there is a high degree of luck or chance concerning the future value of the business. There are also two additional aspects to consider: (1) the nature of the investment made by the venture capital funds and (2) the nature of the venture capital funds themselves.

Investment by venture capital funds are made following careful due diligence by the fund manager's team of investment specialists. After the investment is made, that team will work very closely with the management team of the company as it develops and implements its business development plan, requiring adjustments and refinements as necessary depending on market conditions and how progress towards the milestones set at the time of the initial investment develops. Investment by the venture capital fund tends to be drip-fed into the business contingent on the progress made towards these milestones. The decision to provide each round of funding is being considered with the benefit of the more detailed insight and understanding of the business and its prospects gained by the close involvement with the management team. This is not the sort of one-off, short-term, high-stakes decision making that paragraph 51 seems to be targeting.

When it comes to the venture capital fund itself, a commitment to a fund is only made after months of careful due diligence, and, taking into consideration the risk profile of the whole private equity and venture fund portfolio of the investor. As explained above, the ultimate return on investment for the bank will be determined not by the success of one specific company, but by the total return achieved on all the companies in which the fund has invested. This mitigating factor is a key element in the bank's decision to commit capital into a venture capital fund.

Finally, the carried interest structure, a profit share mechanism which is typical of all private equity and venture capital funds, means that the fund manager will only be rewarded on the basis of the realised performance of the fund as a whole and over the long-term.

For these reasons and the ones described in our response to Question 24, we would suggest removing any reference to "venture capital" in the proposed definition of "speculative unlisted equity exposures".

Question 25. What other measures could be put in place to address the elevated risk from unlisted equity exposures?

Please elaborate and provide relevant evidence.

As shown above, one of the ways to limit the risk created by banks' exposures to unlisted companies is for banks to gain exposure through a diversified portfolio of funds.

For reasons we have detailed in the responses to the two previous questions, this would mitigate, due to the benefits of fund diversification, much of the concern regarding the sometimes elevated risk of unlisted exposures. Giving investments in funds a more appropriate capital treatment would therefore be an excellent option to foster banks' investments in less volatile unlisted equities and into long-term portfolios.

II. Treatment of CIUs

Question 150. What are the proportion and characteristics of the CIUs where a look-through is possible and how frequent is this possible? Please provide relevant evidence.

We are not in a position to comment on the frequency of the ability of looking-through, but we can share information on the circumstances in which a bank would or would not be in a position to follow the look-through approach.

We would like to stress in that context that, even though the bank will typically be in possession of the relevant information to determine the material risk of underlying investments, it may not always be easy for the credit institution to comply with the look-through approach.

On the one hand, it is indisputable that investors in venture capital and private equity funds know exactly what the fund is investing in. From the outset, the bank investing in the fund will have conducted its own due diligence to fully understand the investment strategy to be followed and what type of companies will fit that strategy. Once the fund begins investing, there is regular contact between the investor and the fund manager, both in person and through detailed quarterly reporting. Many funds also provide investors with updates , on the total investment made in the company, as each new investment is made. They also give to their investors information about what the company does and what the investment rationale is for investing in it. As such, it is abundantly clear that such investments meet the criteria for having look-through applied to them.

It should be noted that when a venture capital or private equity fund invests in an unlisted company, the capital structure of that investment is invariably in some combination of ordinary equity, preferential shares (of which there may be many types) and junior loan stock. Consequently, it is far less common that fund managers report on the detailed make-up of the capital structure of the fund's investment in the underlying company. In the context of the relative risk of loss associated with any one company in any one fund in the investor's portfolio of funds, this is a level of detail that is unnecessary. Consequently, being able to identify the value of the indirect exposure to the ordinary equity of the underlying companies is not something that is either requested by investors or provided by fund managers.

In those cases where a bank judges that it is not in a possession to look-through the underlying investment (irrespective of the amount of information it has in its possession to assess the risk of such investment), then it would be essential for the bank to be in a position to use the mandate-based approach. As we explain in more details in the response to Question 151, the current conditions to use the mandate-based approach may be too restrictive for investments in unlisted equity and we would therefore support making amendments to that approach.

Question 151. What are the proportion and characteristics of the CIUs traded in the EU for which the mandate of the CIU is available and daily price quotes can be obtained? Please provide relevant evidence.

As we already explained in our response to the European Commission "Targeted consultation on the approach to market risk", 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 context of investment in listed equities (whether directly or indirectly through CIUs) are simply not feasible and thus do not exist (daily or otherwise). Transactions in private equity fund interests are individually negotiated transactions, where no stock exchange is involved and in many cases a number of interests in different funds are bundled in one transaction.

It is a 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. If an institutional investor in private equity funds is required as part of its broader internal reporting or compliance purposes, to identify a "daily value" for its private equity portfolio, 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. It may be worth recalling in that context that (in a private equity fund, commitments are made and drawn down over time and distributions are made as they arise).

We therefore believe that the proposed approach should be more flexible 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.

Contact

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About the PAE

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

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