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

Response to EIOPA Consultation Paper on the Opinion on the 2020 review of Solvency II

Introduction

We would like to thank EIOPA for providing us with the opportunity to comment on its draft "Opinion on the 2020 review of the Solvency II framework". As representatives of the private equity industry[1], our comments to this consultation paper will focus on EIOPA's analysis of the treatment of long-term investments under the Directive (Chapter 2.9) and, more specifically, on the impact of EIOPA's proposed changes on the insurers' ability to commit capital to private equity funds.

Private equity funds are for all intents and purposes long-term assets. When an insurer is gaining exposure to unlisted companies through a private equity fund, it does so by making a commitment to a closed-end fund that has a ten year lifespan (often extended by two further years or more) on average. The private equity model itself is characterised 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 therefore unsurprising that the feedback we have so far received from our members shows that insurers, when they decide to set up long-term equity portfolios, will seek to classify their exposures to private equity within the new long-term category, subject to the criteria of Article 171a of the Solvency II Delegated Acts. As there is currently an insufficient supply of long-term financing in Europe, it is important that the crucial measures designed to support financial stability do not end up having the ultimate effect of penalising long-term assets. There is an appropriate balance to be struck between addressing prudential concerns and preventing insurers from providing capital to businesses.

From our industry's perspective, long-term equity risk weights certainly influence the ability of insurers to play their role in supporting start-ups through venture capital funds, scale-ups through growth capital funds or large-scale infrastructure projects through infrastructure funds, by supplying the vital financial component of the patient capital model. After carefully considering EIOPA's analysis on the risk of long-term equities, we fear that it does not fully reflect the real risk of an investment into these portfolios. We believe this is due to the following assumptions behind the approach taken by EIOPA: the risk of illiquid, long-term equity exposures is assessed by comparing it to listed equities held for the long-term, without taking into consideration: (a) the

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[1] Invest Europe's membership covers all private equity activity, from early-stage venture capital through to large private equity firms and funds investing in infrastructure. In this paper we will use the term private equity as referring to all these activities. Our membership also includes institutional investors, such as pension funds and insurance companies, as a key source of long-term financing in Europe and who invest in private equity, venture capital and infrastructure funds.

insurers' business model and way they structure their long-term portfolios; and the specific criteria of the long-term equity category (in particular the inability for the insurer to sell its assets) that reflect the characteristics of these portfolios (b) the index chosen covering only listed markets, while, in our case, portfolios will be almost exclusively made up of unlisted equities.

In light of this, we would like to recommend EIOPA to take into account the characteristics of long-term commitments, which are less susceptible to be sold at a certain point of their life, when assessing the risk of the new long-term equity category. Moreover, as it recognises implicitly the benefits of risk diversification within the long-term equity portfolios, we also invite EIOPA to consider whether diversified long-term equity portfolios could also in some cases represent a risk lower than the one set for the new category. Existing literature on the risk of investing in private equity indeed shows that such portfolios may be effectively risk free beyond a certain level of diversification.

We of course stand at the disposal of EIOPA should it need any additional information on the specificities of insurers' commitment into private equity funds and on the role diversification plays in lowering the risk of a portfolio.

Comments

Analysis of long-term risk (Chapter 2.9. (paragraphs 2.830 to 2.844))

The fundamental concern we have with EIOPA's analysis is that it looks at the risk of investing in long-term equities solely from the perspective of listed, liquid investments which are, by nature, investments with are intended to be traded and are very much not like fixed-term private equity fund investments that are expected to be held until maturity. Differences in the risk profiles of these two very different types of assets simply cannot be ignored. Therefore, our main concern with EIOPA's analysis relates to, and is consistent with, our general concerns with the way risk is assessed for long-term equity funds, namely, that EIOPA is not taking into consideration the different nature of the risks associated with investing in a portfolio of diversified private equity funds compared with the risks associated with investing in a portfolio of highly liquid listed equities.

While we do not challenge the model used by EIOPA (besides the use of the index – as we explain below), we believe that the fundamental assumptions behind EIOPA's analysis are not correct. From our perspective, the most controversial angle of EIOPA's assessment is that it essentially considers the long-term equities as if they are short-term, tradeable equities held for the long-term. We see this as a direct result of the assumption that one necessarily has to look at the minimum value of the VaR during a 1-year time period of the investment to determine its risk. As recognised in many reports, and in particular the "Betting on the long-term report" prepared by the Paris Marketplace, this approach always overestimated the risk of long term equities and made it harder for insurers to commit capital into long-term assets that match their liabilities profiles.

Insurers' exposures to private equity funds are a good example of this. As explained in the introduction to this response, an insurer will commit capital to a private equity fund for an average of ten years. This investment will not be subject to redemption rights. Only a small proportion of private equity investors will effectively sell some of their private equity investments through a secondary sale of their participation in the fund (as indicated by relatively low, albeit growing, secondary market volumes), which means that the insurer does not invest in private equity funds with the "buy and sell" mindset of when it invests in listed equities, which it fully intends to trade: <u>selling its exposure to a private equity fund is never the intention from the outset and in practice only ever happens occasionally and for very specific reasons</u>. Because of this, the short-term fluctuations in accounting value, which EIOPA wrongly correlates with listed equity markets fluctuations, would only be relevant if those long-term investors did not intend to hold their private equity assets until maturity. It is true that were an insurer to sell its stake in a private equity fund in the early years of the funds' life it would be likely to suffer "losses" relative to the returns it would likely achieve if the investment were held for its full term for the simple reason that the investment has not yet matured and the future potential value of the investment is simply not yet reflected in the NAV (as the fund manager is still actively creating value at the level of the portfolio companies that the fund has invested in). In reality the only real loss generally suffered if a fund participation is sold in the early years of a fund's life arises from the fact that all fees and running costs for a fund are paid out of the capital of the fund and not charged to the investor separately. However, the Solvency II framework so far fails to recognise that this phenomenon, called the "J-curve" in a private equity context, is well understood by the insurers. When an insurer does decide to sell a private equity fund position, it will invariably be in more mature funds in which the insurance firm has already generated value from its investment and has left some unrealized value on the table for the secondary buyer.

We would cite as evidence the reality how insurance firms acted in the wake of the most recent financial crisis ten years ago: there was little evidence of any premature or forced selling of their private equity fund investments in insurance firms' private equity fund portfolios. This is because they had been established following due consideration of the overall risks and liabilities faced by the insurer, and following measured, strategic decisions as to what proportion of total assets could prudently be allocated to long-term private equity investments, and how best to manage those investments. A survey conducted by Invest Europe in 2013 showed that, even taking into account the financial crisis, the total capital that had been lost by the respondents (either through total loss of fund or a return of less than one to the total value of paid in capital) in fully realised private equity funds was less than 1% of current capital committed by respondents to private equity funds and was vastly offset by overall gains in the private equity portfolio. Moreover, the default rate of private equity backed businesses was 2.8%, compared to 6.2% for other companies during the recession of 2008-2009.

The concern we have always had is that the benefit of not having to be a forced-seller of private equity funds and being able to continue to hold the asset for the longer-term, during which time any diminution of "value" recovers and indeed grows beyond the level at the time of the crisis, has so far simply not been considered within the general Solvency II framework. It is however accounted for in the criteria of the new long-term category. Requirements for such a category, and in particular those set out in criteria (e) (holding period) and (g) (forced sales), exist precisely to distinguish long-term equities from short-term ones. When a portfolio meets those criteria, it makes little sense to calculate the risk of selling the equity on the worst day of the year for a portfolio that has *already* been designed to avoid forced sales. We note in that context, that EIOPA has offered up no evidence to substantiate the notion that insurance firms are either forced sellers of long-term equity holdings, or manage their portfolios in a manner that would be detrimental to, or inconsistent with their liabilities.

For that reason, the new long-term equity category will be extremely relevant for insurers' commitments to private equity funds. Indeed, it will be extremely unlikely (or potentially even nonsensical) for an insurer to sell its participation in a private equity fund on a (low volume or non-existent) secondary market because of a surprising election result or any other sudden one-day drop in value of the equity (as is supposed to be the case under EIOPA's model). On the contrary, the insurer will by nature seek to keep this equity within its portfolio through the economic cycle and wait for the full potential value of the investment to come to fruition.

An insurance exposure to a private equity fund therefore ought not to be seen as so sensitive to the "values of assets, liabilities and financial instruments to changes in the level or in the volatility of market prices of equities". In other words, it would already be much preferable for equities held in long-term portfolios that meet the criteria of Article 171a, to look at an "anniversary value" rather than at the lowest year daily value of a private equity portfolio (which is likely to be meaningless from the insurers' strategy perspective). Finally, on a more pragmatic note, we find the analysis flawed as it has again been based on a listed market index. The MSCI index is not representative of a portfolio of private equity fund investments held by insurance companies either in terms of content, or, more importantly, in terms of the price volatility, liquidity or any other definition of risk faced by the portfolio. A 2013 survey carried out by Invest Europe showed that only 0.3% of the total capital committed by respondents to private equity was held in listed private equity and venture capital vehicles. EIOPA itself even recognised this in its 2013 paper that listed equities index are not necessarily good proxies for unlisted equities – as it stated at the time that "the performance of unlisted PE firms and funds may be different to the listed companies represented in the LPX50 index" (it is also worth pointing out that the MSCI index is even less appropriate than the LPX50 was at the time). We believe the choice of the proxy is therefore deeply problematic and puts in question the relevance of EIOPA's findings for investment in unlisted private equity funds.

In conclusion, while we understand why EIOPA is following an approach where "market risk" is due to reflect the structural mismatch between assets and liabilities, we believe that the results of its analysis are simply not valid for investments held within long-term portfolios. On the other hand, we believe that EIOPA's assessment actually is a good way of demonstrating why maintaining the long-term equity category as a "safe haven" for long-term equities is absolutely essential to ensure that Solvency II ceases to disincentivise investments in such assets.

Diversified Long-term equities portfolios (Chapter 2.9. - paragraphs 2.958 to 2.960)

While we believe that a long-term equity portfolio need not be diversified to be granted the 22% risk weight, we welcome the fact that EIOPA now recognises that diversification within the long-term equity portfolio lowers the risk of such portfolios. We believe this is a significant breakthrough in the way the EIOPA is prepared to consider the assessment of risk. We have explained that the current Solvency II framework does not sufficiently take into account the benefits of having diversified portfolios of private equity funds for an insurer (on top of the diversification benefits of investing in different asset classes). As indicated in the BVCA Risk in Private Equity report (2015), and in many other publications related to risk in private equity, in the long-term, "investors are able to minimise their risk significantly when diversifying over a large number of funds in many geographies, industries, and over many years and with different fund managers."

From that perspective, it is worth pointing out that data that was collected among insurers and pension funds in 2018 shows that an institutional investor does not need to invest in hundreds of funds to achieve a portfolio that is deemed to be sufficiently diversified from a risk perspective. This survey, which Invest Europe commissioned from Europe Economics, indicated that an insurer investing into a diversified portfolio of only 7 direct private equity funds already should receive a risk weight as low as 18 to 23%. It should be noted, that most insurance firms with well-established private equity fund portfolios hold significantly more funds than this.

Finally, if diversification is to be taken into account, the logical follow-up is that a risk weight of 22% should not necessarily be seen as a lower limit. Indeed, prudently diversified long-term portfolios (such is typical for a portfolio of private equity funds), with funds held that are at different stages of their life, diversified across sectors, geographies, fund managers and stages of investment, may ultimately represent a very limited risk for the investor, and potentially much lower risk than even the 22% of the long-term equity category. The

Europe Economics study referred to above shows that the risk of a portfolio of 15 funds would only require a risk weight of 7 to 13%, while portfolios of 25 funds are essentially "risk free". That analysis is also confirmed by other papers (see for example Diller and Herger, Assessing the risk of private equity fund investments).

Diversification between LTE and other risks (Chapter 2.9. – paragraphs 2.964 to 2.965)

We believe that a solution should be found to ensure that long-term equity investments continue to be diversified with other risks, irrespective of the issue posed by the different year time horizons. If a solution cannot be found, it would then be essential for the risk weight of the long-term equity category to take into account, within the long-term equity category itself, the diversification benefits of investing in a diversified portfolio. As we mention in the comment above, the risk weight of the category could then, quite justifiably, be much lower than 22%.

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.

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.