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

## Response to ESMA Consultation on draft Guidelines on leverage limits

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**Q1. What are your views on the frequency at which the risk assessments should be performed by NCAs?**

*[EXTRACT: NCAs should perform the risk assessment on a quarterly basis in line with Article 110(3)b-c of Commission Regulation 231/2013, AIFMs shall provide NCAs with the AIFMD data reporting on a quarterly basis for the leveraged AIFs they manage. The leverage risk assessment should be completed by the NCA following the receipt of data by the AIFMs].*

Given ESMA's intention is to broaden the scope of its analysis on funds that are covered in point (b) and (c) of paragraph 3 of Article 110 of the Delegated Regulation, we would like to point out that several types of AIFMs are currently not obliged to report on a quarterly basis.

The frequency at which the risk assessment is provided to the NCA should therefore be modulated to the one that is currently required under Article 110, if only for the Guidelines to be in line with the Delegated Regulation.

**Q2. What are your views on the sample of funds to be included under Step 1? Do you agree in including in the risk assessment not only substantially leveraged funds but also funds not employing leverage on a substantial basis which may pose financial stability risks?**

*[EXTRACT: Under Step 1 (Level, source and different usages of leverage), NCAs should identify not only AIF employing leverage on a substantial basis but also non-substantially leveraged AIFs which may cause risks to financial stability and thus need to be assessed under Step 2.]*

We endorse ESMA's two-steps approach: first, eliminating those funds unlikely to pose risks to the financial system, and second, performing a risk-based analysis on those funds that remain. We note that the main goal of such an approach is to ensure no time is wasted looking at funds that clearly pose no concern from a financial stability perspective.

In that context, ESMA appears to want to also cover non-substantially leveraged funds in its Step 1 analysis. The rationale seems to be that some of these funds may, despite being moderately leveraged, have strong interconnections with the rest of the financial system, which naturally increases the impact of such leverage on the overall financial stability.

If that is indeed ESMA's goal, then it would also make sense to more clearly exempt non-substantially leveraged funds that are not deeply interconnected with other financial institutions. Such an exemption could be granted provided it is clear these funds have very limited financial exposures to other participants in the financial system and thus have limited counterparty exposure. This should be irrespective of whether they would be deemed to have an "unusually high level of leverage" compared to their peers, especially as this concept is not defined in the Directive.

To this end, we propose for closed-ended private equity funds to be excluded from Step 1 of the assessment (see response to Q3 below).

**Q3. Do you agree with the proposed threshold identified under Step 1? Would you set the same threshold for all AIFs, or would you be in favour of setting different thresholds based for different types of AIFs (e.g.: real estate, hedge funds, private equity etc) or sub-types of AIFs (please specify) based on a statistical analysis (e.g. percentile)? Should you prefer the latter option, please provide proposals and detailed arguments and justification supporting them.**

*[EXTRACT: For the purpose of point c) of paragraph 13, an "unusually high use of leverage" is a use of leverage that differs significantly (e.g. a high percentile in the distribution) from that of other funds by comparing the AIF's leverage value with: a) the median or average value of leverage of AIFs of the same type (for example: hedge funds, private equity, real estate, fund of funds and other AIFs); and b) the AIF's historical median or average leverage value.]*

We believe the same threshold should apply to all AIFs.

While we are generally in favour of approaches that are not "one size fits all", we are not convinced in this case there is a need to differentiate between types of funds to determine what is an "unusually high level of leverage" (see our comments on this concept at the end of this answer).

As per ESMA statistics, outside hedge funds, most AIFs only use a very moderate amount of leverage at fund level. As explained in the Annex to our response, this may for example be due, in a private equity context, to their use of derivatives for hedging purposes or of making staged investments into portfolio companies, as opposed to a deliberate leverage strategy.

The level of leverage is so low in some AIF structures that a fund having an "unusually high use of leverage" compared to the norm will in many cases still pose no concern from a financial stability perspective. In other words, the fact that one private equity fund has a *higher* short term leverage level *than another* does not necessarily make it a systemic problem in the context of the leverage or liquidity risks that could be created by certain types of (typically hedge) funds. For closed-ended funds, it may also be difficult in practice to determine a median or average value of the AIF.

The purpose of a differentiated approach should be to define the risk posed by fund managers and their funds <u>based on their characteristics</u> (such as their closed-ended nature or their lack of interconnection with the rest of the market) <u>and the ones of their portfolios</u>. Allowing for a proper ex-ante assessment of what should be considered to give rise to systemic risk in the fund activities is more helpful from that perspective than setting different thresholds. The ultimate goal of a differentiated approach should be to enable national competent authorities to narrow their focus and accurately identify and report the real systemic risks posed by the use of leverage. <u>If the peer group's characteristics are not inherently risky</u>, benchmarking funds to their own peers and finding that some inevitably use more leverage than others is not productive.

Under the proposed Guidelines, private equity closed-ended funds, which in practice, do not pose the risks set out in Step 2 of the assessment will be captured under Step 1. As ESMA's intention is to capture AIFs employing leverage which may pose a risk to financial stability, closed-ended AIFs by virtue of their structure make the risks in Step 2 an unrealistic possibility. Private equity funds are typically structured as ten year (or longer) closed-ended funds, where investors make a legally binding commitment for the duration of the life of the fund with no right of redemption before the end of the fund's life – the AIFM equally does not have a right to operate a "redemption policy" at its initiative (as further detailed at Q4 below). There are also no risks of "fire sales" or direct spill-over to financial institutions. Therefore, private equity closed-ended AIFs should be excluded from assessment at an early stage unless they are substantially leveraged.

However, it should also be borne in mind that closed-ended private equity AIFs could be inaccurately labelled as substantially leveraged, even though they do not pose any substantive risk of impacting the market. The gross and commitment methods can yield very high leverage numbers for AIFs where there are natural gaps between the points at which investor capital is drawn down and at which the capital is invested. As noted by IOSCO, the use of derivatives for hedging (i.e. interest rate, currency or other hedging) also distorts these calculations, as notional contract amounts rather than their market values are inputted (as further commented at Q5 below).

Finally, ESMA should at the very least clarify what it means by "unusually high level of leverage" as this may still represent insubstantial amounts compared to other types of funds and significantly below what has been deemed to be a relevant size by the regulator (the concept of "substantial leverage"). Introducing yet another concept of a level of leverage may not be helpful from a clarity perspective.

**Q4. Would you identify other relevant transmission channels?**

*[EXTRACT: 20. When assessing leverage-related systemic risk, NCAs should at least include the following risks:*
*a) risk of market impact;*
*b) risk of fire sales;*
*c) risk of direct spill over to financial institutions;*
*d) risk of interruption in direct credit intermediation]*

No, we do not identify other channels for private equity funds.

Moreover, some of the transmission channels listed by ESMA are in fact not at all relevant in a private equity context. The "risk of fire sales", which is deemed one of "most concern" for private equity funds in the Annex II case studies, is in fact very different for a closed-ended, long-term fund context than for an open-ended one. For that reason, we disagree with ESMA's assessment that the illiquid nature of private equity funds poses the same concern as funds faced with short-term redeemable claims. This is why we propose to exclude closed-ended private equity funds from Step 1 of the assessment (see response to Q3 above).

When institutional investors, such as banks, insurers or pension funds, commit capital to a fund, they are aware of the risks of having committed their capital to the fund for a long-term period – usually for ten years or longer. They have also signed a comprehensive "limited partnership" agreement with the manager and redemption by investors during the life of the fund will typically be prohibited by the contractual documentation. As a result, these funds are structured in a way that avoids the potential for fire sales of the sort that in other asset classes could drive down investment values and adversely affect other participants in the financial system. The liquidity risk associated with a private equity fund's activity and the risk of a maturity mismatch in connection with its investments is therefore minimal and there is no short-term pressure to liquidate significant volumes of assets simultaneously.

These specificities should be taken into account by ESMA if it intends to examine private equity funds as contributors towards the build-up of systemic risk in the financial system – as they play an important role in the way the funds operate and structure their investments.

**Q5. What are your views on using not only leverage indicators, but also other types of indicator such as those indicated under Table 2 of the draft Guidelines? Do you agree with the list of indicators provided?**

As explained in our response to Q4, we believe that, while most proposed indicators are relevant, they will not always be in some specific contexts. For example, the share of illiquid assets should not be regarded in the same way in an open-ended hedge fund and in a private equity fund, where the fund is structured to ensure that assets will not be sold until the end of the fund life.

Regarding the set of indicators to determine whether a fund is leveraged in Step 1, we would like to make a series of comments on the use of the gross and commitment method in the AIFMD which may be of interest to ESMA:

a. The gross method

As it expresses a ratio between the total absolute value of all long and short positions held by the fund and the fund's NAV, the gross method can be a useful measure to give an idea of the "fund's footprint".

However, it fails to capture the fact that, in a private equity context, investments made by a closed-ended fund will be backed by uncalled commitments. As a result, the use of this method could lead to the conclusion that a fund is modestly leveraged while, in practice, investments that are made may pose very little (if any) risk from a financial stability perspective.

In addition, and as recognised by IOSCO in its recent leverage report, the gross method does not allow the effects of hedging or netting to be recognised as a means of reducing a fund's exposure, potentially leading to the perverse result that two positions could perfectly offset each other and reduce a fund's net economic exposure to zero and yet the value of both positions would need to be included when determining the fund's exposure value. From a policy perspective, this may also have the (unintended) consequence of discouraging funds from entering into hedging arrangements (because of the risk that the fund may be considered leveraged as a result), even though such hedging is, in fact, more likely to be an important risk management tool.

Under the AIFMD framework, any leveraged fund according to the gross method is automatically required to maintain liquidity management systems and procedures, which does not take into account the fact that AIFMD applies to not only open-ended but also closed-ended funds. As a consequence, the use of the gross method forces some closed-ended funds to maintain liquidity management systems and procedures despite the fact they are not posing any liquidity risk (as recognised by the FSB in its conclusions on structural vulnerabilities[1]).

b. The commitment method

The commitment method, based on a ratio between the net exposure of the fund and the fund's NAV, is better tailored to the actual risk posed by private equity fund managers, although it does not address the problems posed by uncalled commitments. This measure is in consequence more helpful to assess the actual risk posed by the fund from an economic perspective, particularly as it takes into account netting and hedging arrangements (although there are criticisms of the tests for hedging and netting, as explained below).

The AIFMD commitment method however contains flaws because it does not specifically exclude cash from the calculation of the exposure, to the contrary of the gross method. Given cash or cash-equivalents do not pose market risk, our opinion is that these should not be included in the definition of the exposure and that the

[1] Financial Stability Board, Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, January 2017

current approach of AIFMD, where the treatment of cash is different in the gross and commitment methods, may be a drafting oversight. Including cash in the definition of exposure under the commitment method would give rise to a misleading result because cash which was available to settle a liability would have the effect of both increasing the NAV and increasing the exposure. As a result, the fund would have a leverage ratio above 1:1 despite it having more than enough cash to cover a liability appearing on its balance sheet of an equivalent amount. In our view, this cannot be the intended result.

In addition, although the commitment method recognises some forms of hedging and netting, it has been criticised for the vagueness of the tests to determine eligible netting and hedging arrangements which, in turn, introduces uncertainty as to whether a private equity fund can rely on the netting or hedging provisions for these purposes.

**Q6. What are your views on using not only AIFMD data but also other external data sources to perform the assessment? Which types of external data sources would you consider more useful for the purpose of performing the assessment under Step 2, other than those already identified in Annex of to the draft Guidelines?**

While consistently reliable external data will exist for listed instruments and public markets, this will generally not be the case for private capital portfolios. For that reason, the data submitted under AIFMD should be the key source for national competent authorities.

**Q7. Which other restrictions would you consider as appropriate?**

We do not believe any other restrictions to the proposed ones should be introduced.

**Q8. What are your views on the application of the leverage limits? Should those be applied only on the single fund or, where appropriate, limits should also be applied on group of funds? In this case, how would you identify the group of funds?**

Private equity funds – even where they are managed by the same fund manager - are not exposed to each other as they neither pledge their assets as security nor guarantee each other's obligations. Any portfolio company group into which a fund has invested is managed independently and has its own specific holding company, protecting both other portfolio companies and other funds from the implications of those investments being unsuccessful. Even if a private equity fund is unsuccessful in its investment strategy, it should not pose contagion risk or have systemic risk implications in the same way as an entity which is strongly inter-connected might.

**Q9. How would you assess the efficiency of leverage limits in mitigating excessive leverage?**

N/A

**<u>Contact</u>**

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

## Annex I: General comments on private equity and leverage

Private equity funds are closed-ended funds, which are often structured as limited partnerships. Institutional and sophisticated investors make a contractual, binding commitment to the fund, which is drawn down when needed, to be invested in businesses. Private equity funds are not typically leveraged and do not use leverage, as that term is normally used, at the level of the fund[2].

While private equity funds may sometimes be able to make use of a short-term borrowing facility, or have the ability to use derivatives to hedge the risk of their foreign currency exposures, these activities will systematically be backed by undrawn commitments.

We believe that the concept of leverage should be limited to those activities which increase the exposure of a fund in a similar way to, for example, cash borrowings or speculative derivatives trading at fund level. An agreement to put more money into a company subject to conditions which, once completed, also increases NAV, should at very least not be deemed comparable, and not to give rise to same financial stability risk, as traditional examples of leverage.

The four, non-exhaustive, examples below show that some activities carried out by private equity funds may fall within some technical leverage definitions, and in particular the gross method currently used in an AIFMD context. These may partly be the reason why ESMA considers that a typical private equity fund is slightly leveraged.

We invite ESMA to take this into consideration when determining whether a fund has to be assessed under Step 1 and to clarify what are the relevant transmission channels in Step 2.

**Funds' investment in portfolio companies**

***What is it?*** Long term borrowing for investment purposes will often be contractually prohibited at fund level. It however can be convenient for a fund to complete an investment into a portfolio company *before* drawing down the corresponding capital commitment from its own investors. In such a case, a prudent fund will use a "short-term borrowing facility".

***What is the purpose of such practice?*** It gives the fund manager more flexibility in executing its investment strategy.

***When is it used ?*** Fund managers can use the facility to ensure that capital is available to complete the investment exactly when needed. After the investment is completed, they will send a draw down notice to investors for the exact amount needed for the investment.

***What are the benefits for the manager?*** This avoids unnecessary cash flows to and from the fund and reduces the overall administrative burden for both investors and fund managers.

***Does this poses a risk?*** Funds' investments into the companies they support are structured as equity or as shareholder debt. Most importantly, they are **backed by contractual, binding, uncalled commitments from investors** to contribute capital to the fund on an on-demand basis. If the fund borrows at fund level to make the investment, the lender will usually take security over the right of the manager to call these uncalled commitments.

***Does this increase the funds' exposure?*** Not in the traditional sense. Indeed, the fund will never borrow more that it has available from investors to repay the loan. The risk arises from the institutional investors default on the commitments they have made to the fund, which is extremely rare even under stressed conditions.

[2] See paragraph on debt at portfolio company level to understand why debt at portfolio company level is currently, rightly, excluded from leverage reporting in AIFMD.

***Could this be treated as leverage?*** Yes, for example under the gross method. Any test for leverage that is predicated on the relationship between exposures and NAV (for example, the gross method used in an AIFMD context) could misleadingly treat such practices as if they were leverage used to magnify exposures. Uncalled commitments will typically not be reflected in the fund's net asset value ("NAV") under applicable accounting frameworks, even though they are available on demand and there is no material risk of default.

***Is it considered leverage under the AIFMD?*** Not in most cases. Short term borrowing facilities are rightly excluded from the calculation of leverage under the AIFMR (Article 6.4).

**Debt at portfolio company level**

***What is it?*** Some private equity strategies, such as leveraged buyouts, involve leverage at the *portfolio company* level.

***Can this have an impact on the leverage of the fund?*** No, the borrowing at the level of the portfolio company will have no bearing on the leverage of the *fund*. Indeed, for each acquisition by private equity fund managers, the debt held by each of its individual portfolio companies will typically be **structurally and systematically siloed (i.e. ring-fenced)**, both from any debt of the fund itself and from the debt of any other portfolio company controlled by the fund. This model protects against contagion risk and systemic risk to the financial system as it ensures that even the possible failure of a portfolio company does not impact either other companies owned by the manager or the fund itself.

***Is it considered leverage under the AIFMD?*** No, the AIFMD framework recognises that exposures of the portfolio companies do not constitute leverage for these purposes (see for example Recital 78 of the Directive: "for private equity and venture capital funds […] leverage that exists at the level of a portfolio company is not intended to be included when referring to such financial or legal structures").

***Are these companies more likely to fail?*** No. The level of leverage in the portfolio company does not automatically lead to higher risk of failure for these companies. Due to private equity managers' active management style and careful consideration of the company's ability to take on and service debt in the first place, many studies demonstrate that the default rate for private equity-backed companies is actually lower than for similar publicly-owned companies with a comparable amount of debt[3].

**Use of foreign exchange derivatives**

***What is it?*** Some private equity funds may also transact in foreign exchange derivatives.

***Does this increase the funds' exposure?*** These derivatives will generally only be used for hedging purposes with the objective of reducing foreign exchange risk when engaging in foreign markets.

***Is it considered leverage under the AIFMD?*** While the use of derivatives at the fund level will be backed by the fund's undrawn commitments (see point 1), it may, as explained above, be considered as an exposure of the fund for the purpose of some methods of measuring leverage. This would in particular be the case of the

[3] 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. Several studies have also found that private equity-backed companies generally have better corporate recovery and survival rates (Frontier Economics Report, *Exploring the impact of private equity on economic growth in Europe*, May 2013). 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 (3.97% versus 4.62% between 1998 and 2011 in the US - in Europe, the default rate is up to 25% lower than for non-private equity backed companies) (Kaplan and Strömberg (2009), based on 3,200 businesses). Moreover, those private equity-backed companies which do default spend less time in financial distress and are more likely to survive as an independent, reorganised company than non-private equity backed companies.

gross method used under the AIFMD (see our response to Question 5).

**“Staged investments”**

***What is it?*** Some venture capital funds may make contractually binding obligations to subscribe for new securities later, subject to certain conditions, for the purpose of their strategic investments. This is generally not be considered to cause "leverage" in the traditional sense (for example, they are comparable to transactions in listed markets where there is usually a gap between trading and settlement, but this gap does not mean that there is leverage during the period prior to settlement).

***Does this increase the funds’ exposure?*** Again, these practices will give rise to exposures of the fund for the purpose of certain methods of measuring leverage, while, in practice, these will be backed by undrawn commitments. Staging is simply a function of how the transaction is structured, and should not, by itself, constitute leverage.

## 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.

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