THE VOICE OF
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INFRASTRUCTURE
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 EC Consultation on the review of prudential rules (Solvency II Directive)

Introduction: The impact of Solvency II on investment into long-term assets

We thank the European Commission for the opportunity to provide our views on the revision of the Solvency II framework. Solvency II risk weights have a major influence on the insurers' ability to support, among others, start-ups through venture capital funds, scale-ups through growth capital funds or large-scale infrastructure projects through infrastructure funds. An appropriate balance must be found between addressing prudential concerns and ensuring that long-term investors remain able to supply capital to long-term projects.

Invest Europe and national venture and private equity associations do not only represent European private equity, growth, venture capital and infrastructure managers – they also speak on behalf of the institutional investors, including pension funds and insurers, which are committing capital to the funds these managers have set up. As such, we take a great interest in the impact the revision could have on the conditions under which insurance companies will be able to finance businesses through long-term equity funds.

Insurers' private equity investments are a good example of the nature of long-term commitments these investors can make. When an insurer makes a commitment to a closed-ended private equity fund, it does so for a fixed ten year period (often extended by two further years or more). During that period, the fund manager (a "general partner") will, on behalf of the fund's investor ("limited partners") finance the growth of a series of unlisted businesses at different stages of their life.

Such model of financing has been defined as "patient capital" because it requires a combination of financial investment of the manager (thanks to the commitment of the investor) and active ownership of the investment (using business management experience to help the company grow and develop). This type of financing also requires for the investors' equity to be "locked" during the time the manager needs to make investments into the portfolio company: it is only when the business has had the time to grow and/or evolve that the manager will sell its stakes and return the profits to the investors while liquidating the fund.

As a result, panic sellings (which are the key risk assessed as part of the equity risk sub-module in Solvency II) are not an inherent part of the private equity market given its illiquidity. Both during the 2008 crisis and during the present Covid-19 crisis we did not witness a significant movement in the secondary space nor an increase in the number of insurers wishing to sell their private equity positions. On the contrary, completed transactions on the alternative investment secondary markets plummeted in the first half of 2020, down 56.1% from transaction volume in the first half of 2019 (Pensions & Investments, https://bit.ly/33hS9pz).

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As we indicate in our response to Question 1, signs indicate that the Solvency framework has incentivised insurance companies to retrench from more long-term and thus illiquid assets. For an insurer, the long-term equity (LTE) category (Article 171a of Solvency II Delegated Acts) is particularly relevant to give its illiquid exposures, such as those to private equity and venture capital funds, a more appropriate risk weight. It "shelters", under certain conditions, illiquid assets from an inappropriate volatility assessment (which is at the core of the equity risk module), hereby taking into consideration their characteristics. Our estimations show that the 22% capital charge is solely appropriate risk weight for not so diversified portfolios and that highly diversified ones (more than 25 private equity funds) essentially become risk realisation free.

For the benefit of both insurers and of the companies they can indirectly invest into, criteria of the LTE category must be appropriately tailored to ensure insurers in all EU countries are able to make use of it and are not too burdensome that insurers that would wish to use it stop short because of regulatory complications.

This is not only valid for insurers using the standardised model. The way in which risk weightings are computed under the standard formula also have a huge impact on internal model's insurers calculations. One has to take into consideration that, usually, a private equity portfolio represents only a small fraction of the total assets under management by insurance companies. This means that, for them, investing resources in calculating *ex-novo* an appropriate risk weight for a private equity portfolio is uneconomic. As a consequence, they may rely on the risk weightings proposed under the standard formula and incorporate them in their internal model, maybe with some adjustments (usually even more conservative).

Question 1: What could be the renewed objectives of European legislation for insurance companies ? On a scale from 1 to 9 (1 being "not important at all" and 9 being "of utmost importance"), please rate, and if possible rank, each of the following proposals.

Policyholder protection	8
Financial Stability	7
Fostering investments in environmentally-sustainable economic activities which will be defined in the EU taxonomy	7
Fostering long-term investments in the real economy and providing long-term financing to European companies, including SMEs	8
Ensuring a fair and stable single market	6

If you identify other political objectives, please specify them and give a rating of their importance from 1 to 9 for each of them:

In our capacity as representatives of insurers committing capital to private equity and venture capital funds, we would place a great emphasis on the "long-term financing of companies" and, more specifically long-term equity investments. Despite the policymakers' objective to support these, over the past few years, insurers' investment in equities have been reduced by half, from 20% to 10% of their total assets[1].

As Solvency II capital requirements made equity investments less attractive, it became part of a general trend that forced insurers to withdraw from this asset class as a whole and disproportionately affected some types of long-term equities. According to EIOPA, only 0,6% of insurers' investments are made in private

[1] Paris Market Place Report "Betting on the Long-Term"

equity funds[2]. Over the past five years insurers made up only 10% of the total investor base in all private equity – 3 times less than pension funds[3]- despite insurers' investment portfolio assets representing 58% of the EU GDP[4]. These numbers show how relevant this objective must be in the future review.

Question 2: In light of market developments over the recent years, in particular the low or even negative interest rates environment and the Covid-19 crisis, what should be the priorities of the review of the European legislation for insurance companies? On a scale from 1 to 9 (1 being "low priority" and 9 being "very high priority")? Please rate, and if possible rank, each of the following proposals.

Ensuring that insurers remain solvent	8
Ensuring that insurers' obligations to the policyholders continue to be fulfilled even in the event that they fail	8
Ensuring that there are no obstacles for insurance companies to contribute to the investment needs of the European Green Deal, i.e. fostering insurers' investments that help the transition to carbon neutrality by 2050	8
Ensuring that there are no obstacles for insurance companies to invest in accordance with the objectives of the Capital Markets Union, i.e. fostering insurers' long-term financing of the European economy, including SMEs	8
Facilitating insurers' ability to offer (sufficiently) high returns to policyholders, even if this implies taking more risks	5
Facilitating insurers' ability to offer products with long-term guarantees	6
Ensuring that insurers do not face liquidity issues (i.e. that they have sufficiently liquid assets) to meet at all times short-term obligations	5
Preventing the build-up of systemic risk and ensuring financial stability	7

If you identify any other objectives, please specify them and give a rating of their importance from 1 to 9 for each of them:

Allowing insurers to commit capital to long-term equity : 9.

Insurers could have a central role in helping the European economy to recover from the crisis that arose from the Covid-19 pandemic. The magnitude of their intervention in this process will certainly be curtailed if the long-term equity category does not become more accessible.

As a reminder, SMEs represent 99.8% of all enterprises in the EU-28 non-financial business sector (NFBS), generating 56.4% of NFBS value added and 66.6% of NFBS employment (EC SME Report, https://bit.ly/3i9KQo0). Halving the global productivity gap between SMEs and large companies would amount to about $15 trillion in corresponding value added (roughly 7% of global GDP) (McKinsey, https://mck.co/3kXqKPB).

Given the low interest rates environment these firms typically have access to low cost debt, which, while helpful for liquidity purposes, does not necessarily foster their future growth, which rather depends on a

[2] EIOPA European Insurance Overview, 2018

[3] Invest Europe/PEREP data, 2018

[4] Insurance Europe, European Insurance in Figures, 2018 data

balanced capital structure combined with a skillful management, typically offered through equity support. Studies have shown how private equity backed firms turn out to be more productive than the ones which do not rely on external resources/managers (Croce & Marti, https://bit.ly/34f0c5P). A recent Invest Europe Report, Private Equity at Work, also demonstrates that private equity backed companies are five times more likely to create jobs (16 times for venture capital) than their counterparts.

For these reasons, it appears obvious that loosening the long-term equity criteria – and hence help insurers support long-term equity funds - may help the European economy to recover faster, by allowing insurers to invest in a broader set of PE funds which, in turn, will have more capital to deploy in needy businesses.

Question 3: Have the recent changes to the prudential framework regarding equity investments appropriately addressed potential obstacles to long term investments?

* No, the recent changes will not have a material impact on insurers' ability to invest for the long term.

Please specify what the remaining obstacles are, and how to address them while preserving the necessary prudential safeguards to ensure policyholder protection

The creation of the long-term equity (LTE) category (Article 171a of Solvency II Delegated Acts) is the best route to increase the insurers' ability to support equity exposures to long-term funds. While it is understandable that criteria must be met by portfolios to ensure portfolios are long-term, we suggest further tailoring these:

Simplify the asset-liability management (ALM) requirements: current "ring-fencing" requirements are too complex for insurers to use and difficult to overcome in some jurisdictions. Further to the insurance industry's suggestions, an option could be to allow portfolios solely composed of exposures to closed-ended funds to always be eligible provided the life of these funds, set in their mandate, is longer than five years.

Expand the geographic conditions: the geographic criteria should be aligned to the others within the equity risk exposure sub-section to at least cover all OECD markets.

Take into consideration the diversified nature of these portfolios: the concept of diversification in Solvency II mostly refers to the investment in different asset classes and different types of equities. The **diversification benefits of a well-constructed portfolio of equity funds** (i.e. diversification of exposure within an asset class) **are not measured** within the framework. Diversification, although a crucial part of every investment, assumes a particularly important dimension in PE funds' investments. BVCA and Invest Europe studies show that the risk of losing any capital over the entire holding period with a portfolio of just 15 funds is already far lower than 22% and that a portfolio can essentially be risk free when it contains 25 or more funds. If it is assumed in the calculation of risk weightings that listed equity portfolios are diversified across industries and sectors, then the very significant impact on risk of diversification across funds by stage, manager, geography, year of investment should at the very least be considered.

Question 5: Do you agree or disagree with each of the following proposed change to quantitative rules in Solvency II?

We should make it less costly for insurers to invest in SMEs	Yes

We should make it less costly for insurers to invest in environmentally sustainable economic activities and associated assets (so-called "green supporting factor")	Yes
We should make it more costly for insurers (and therefore provide disincentives) to invest in activities and associated assets that are detrimental to the objective of a climate-neutral continent (so-called "brown penalizing factor")	No opinion

Question 6: Does Solvency II appropriately mitigate the impact of short-term market volatility on the solvency position of insurance companies?

No.

This question is the opportunity for us to stress that Solvency II made long-term illiquid equities less attractive for insurers unable to use the internal model, ultimately making it harder for these insurers to reap the benefits of long-term exposures, while these typically match the profile of their liabilities and provide them with much needed returns in a low yield environment.

While it is irrational from an economic perspective to consider that an insurer will sell long-term equities, even under times of market stress, **in the same way it would sell daily tradable securities**, this is how the current Solvency II model (with the notable exception of the long-term equity category) has assessed long-term risk. Selling a position in the secondary market – when there is a secondary market - before the date on which the investment period ends is indeed always counterproductive: the fund manager will need time (usually 6 years during the life of the 10 year fund) both to deploy the insurers' capital into the right investments and to appropriately harvest them.

Once it is established (for example by introducing requirements for separate portfolios) that an insurer is unable to sell the equity, and as volatility risk therefore becomes irrelevant, **the only risk for the insurer is the risk of realisation**, i.e. whether it will lose its capital at the end of its investment. Realisation risk is linked to the long-term performance of the fund (and ultimately the success of the underlying businesses and of the patient capital approach) – as opposed to daily changes in value.

This means that, for equities held within LTE portfolios, **it does not makes sense to assess their risk based on their daily "price" volatility.** Indeed, the very criteria of the category ensures equities held within these portfolios are those that are, like exposures to private equity funds, not volatile and not subject to runs.

Question 10: In light of the Covid-19 crisis, have you identified any major issues in relation to prudential rules that you were unaware of or considered of lesser importance prior to the pandemic?

No.

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.

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