THE VOICE OF
PRIVATE CAPITAL
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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 EIOPA Request for Written Comments on its Holistic Impact Assessment on the review of the Solvency II Directive

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Introductory comments:

We appreciate the opportunity offered by EIOPA to share our views on the proposed changes to the criteria of the long-term equity category set in Article 171a of the Solvency II Delegated Regulation.

As a reminder, 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.

We have repeatedly expressed the view that insurers' investments in private equity funds are a good example of the nature of long-term commitments these investors can make and how these differ significantly from listed equity exposures subject to the volatility of stock markets. 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). Most importantly, this type of financing 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, and as we indicated to the European Commission in its recent consultation, **panic sellings (which we understand is currently the key risk assessed as part of the equity risk sub-module in Solvency II) are not an inherent part of our market due to its features.**

Recent crises prove this. 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).

Overall, for any insurer investing in a private equity fund, the structure of the investment **simply makes it economically uninteresting to sell before value is rising** (often after the investment period, or after 4 to 6 years). If this is not factored in, there is a great chance the real risk of such types of long-term investments will simply be disregarded.

That will obviously matter for insurers and for the managers of the funds these insurers invest. But it will also impact the insurers' ability to indirectly invest into high growing and innovative companies these funds support.

For that reason, we believe appropriately tailoring criteria of the LTE category, without subjecting them to an assessment that is only specific to liquid markets, should not be seen as giving a preferential treatment to an asset class. On the contrary, appropriately calibrating the risk of long-term asset classes that insurers must have exposure to if they are has a huge role to play in contributing to the vitality of the European economy and, ultimately, in mitigating the significant prudential risks posed to insurers by low interest rates.

<u>Analysis criteria by criteria</u>

<u>Criteria a</u>

a) the sub-set of equity investments ***~~as well as the holding period of each equity investment within the sub-set~~*** *are clearly identified;*

We appreciate the amendments that have been proposed by EIOPA on this criteria. We note that it is essential to look at this in coordination with paragraph 2 which makes clear that not all investment chains until the last level must be clearly identified.

<u>Criteria b, c and d</u>

b) the sub-set of equity investment is included within a portfolio of assets which is assigned to cover the best estimate of a portfolio of insurance or reinsurance obligations corresponding to one or several clearly identified businesses, and the undertaking maintains that assignment ***~~over the lifetime of the obligations;~~***

1.c) ~~the portfolio of insurance or reinsurance obligations, and~~ the assigned portfolio of assets referred to in point (b) are identified ~~, and managed~~ and organised separately from the other activities of the undertaking ~~and the assigned portfolio of assets cannot be used to cover losses arising from other activities of the undertaking~~;

~~d) the technical provisions within the portfolio of insurance or reinsurance obligations referred to in point (b) only represent a part of the total technical provisions of the insurance or reinsurance undertaking;~~

is replaced by an additional paragraph:

The proportion of equity backing life technical provisions that is assigned to the LTE category does not exceed the proportion of life technical provisions compliant with the criteria specified in number 1 on the total life technical provisions of the insurance or reinsurance undertaking;

We believe that EIOPA's proposals are going in the right direction but will not be sufficient to ensure that insurers are in a position to comply with the requirements, either because (a) "quasi-ring fencing" is a complex exercise for small insurers or insurers with small portfolios, making the use of the category unattractive, or (b) because it does not fit with current national legislation ("level playing field issue").

Regarding point (a), EIOPA must take into consideration that, usually, a private equity portfolio (but more generally any LTE 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 these portfolios is uneconomic. This is also 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. 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)

Taking this into consideration, our view remains that these requirements are too complex for the benefit they would have, at the very least for portfolios where it is clear exposures are long-term. We share the view of the insurance industry that these requirements are unnecessary. They could easily be removed for portfolios composed only of closed-ended funds units, for which the separation of assets can be made easily.

From our own perspective, an insurer which sets up a portfolio only composed of closed-ended private equity funds with a set life of several years, as set in the limited partnership agreement, and where the fund mandate does not allow for redemption rights for the entire length of the investment, should indeed not have to prove that it is a long-term commitment, unless for the demonstration of these characteristics.

Criteria e

e) A policy for long term investment ***management*** *is set up for each long-term equity portfolio and reflects undertaking's commitment to hold the global exposure to equity in the sub-set of equity investment for a period that exceeds 5 years on average.* ***The Administrative management or supervisory board of the undertaking has signed off these investment management policies and these policies are frequently reviewed against the actual management of the portfolios.***

From a pure private equity portfolio perspective, the long-term approach will already be justified in each individual fund, which legally, structurally and economically entails a high level of pressure for long-term investments (the fund being a closed-ended structure of typically 10 years, making investments for over 5 years on average).

For this criteria, we would support the development of a commitment-to-hold approach at portfolio level that would not negatively affect an active management strategy. Indeed, the insurer should be allowed to do active portfolio optimization via selling selective titles which it is not seeing as core anymore or where the market has changed, to give long term-commitments better opportunities.

Criteria f

f) the sub-set of equity investments consists only of equities that are listed in the EEA or of unlisted equities of companies that have their head offices in countries that are members of the EEA;

Our members strongly feel that it would be sounder from a risk perspective to broaden the geographical scope to OECD markets.

All active institutional investors in private equity already have a global investment reach - ironically, this is precisely to ensure they have a risk adjusted diversified portfolio. The very idea of developing a regionally narrowed down portfolio opposes the concept of having a balanced and risk-resilient approach.

We note that the strictness of the current criteria does not even fit with the strategy of the European Investment Fund (EIF), which is a major investor in innovative companies through venture capital. The EIF typically allows for at least some part of their portfolios to be based outside the continent, again to ensure sufficient diversification.

Criteria g and h:

g) Where undertakings can demonstrate that either
i. particular homogeneous risk groups (HRGs) of the life insurance and reinsurance liabilities belongs to category I as defined for the purpose of the calculation of the VA (see paragraph 53) and the Macaulay duration of the liabilities in this HRG exceeds 12 years or
ii. a sufficient liquidity buffer is in place for the portfolio of non-life insurance and reinsurance liabilities and the assigned portfolio of assets;

The liquidity buffer should follow the specification tested in the HIA/CIR

The sub-set of equity investments backing the liabilities identified in i. or ii. can be applied a risk charge of 22% provided the other conditions of this Article are met.
The calculation of the liquidity buffer is outlined in paragraphs 82 to 85.

h) Those elements are reported in the ORSA of the undertakings. For the purpose of the data collection, no such report is requested. For the purpose of the data collection, no such report is requested.

We find EIOPA's suggestions on liquidity to be a step in the wrong direction as these could make the category altogether irrelevant for insurers. As for quasi-ring fencing requirements, rules remains too complex for what they intend to achieve, at the very least for some types of LTE portfolios.

As explained in the introduction, for private equity specific portfolios, practical experience show that fire sales are almost not existent. Therefore, a special future treatment additionally to the current liquidity management would provide no additional value or security.

Most importantly, we invite EIOPA to resist the temptation of using mathematical calculations (such as the Macauley duration) as this will impose significant data gathering and analytical burdens on insurers and, ultimately, on the managers of the funds they invest in. More problematically, this may even restrict access of the asset class if the liquidity buffer is set up on principles that only apply to listed equities, defeating the very purpose of the category.

On this issue, as well as on all others covered in this response, we invite EIOPA to take into consideration the comments made by the insurance industry on the feasibility of such measures from their perspective as long-term investors.

Criteria i

i)	***the sub-set of equity investments shall be properly diversified in such a way as to avoid excessive reliance on any particular issuer or group of undertakings and excessive accumulation of risk in the portfolio as a whole.***

We are not opposed to the very principle that portfolios must be diversified – we are however concerned the proposed clarification adds little value and could create, under certain conditions, barriers to entry.

To avoid this, it should be clarified that diversification means here the number of companies to which the portfolio ultimately has exposure to. The very concept of the private equity industry, i.e. that exposure to companies is gained through fund investments, already allows for an important layer of diversification and is not well accounted for in the Solvency II model due to the way the look-through principle is set up.

For example, a portfolio of 10 private equity fund (a small portfolio by industry standards) already has exposures to hundred of businesses active in different sectors and geographies. The "realisation risk", i.e. the risk of losing its investment (which is the main risk provided the insurer will have proven when setting up the category that it will not fire sale the assets) is already extremely low for portfolios of such size.

We understand there is no willingness at this stage to modify the risk-weights. However, from the prudential point of view of the realisation risk (which again is the one that matters for these portfolios once it has been established the insurance has sufficient liquidity) the risk of a diversified portfolio is significantly lower than 22%, according to all analyses conducted on private equity portfolios,

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.