THE VOICE OF PRIVATE CAPITAL
VENTURE CAPITAL
PRIVATE EQUITY
INFRASTRUCTURE
LONG TERM INVESTORS

Comments on the Capital Markets Union 2.0: the private equity perspective

Introduction

Since the inception of the project in 2014, our industry has been supportive of the two core objectives of the Capital Markets Union: promoting cross-border capital markets within the continent and providing additional financing options for its businesses.

Who we are

Invest Europe represents the entire spectrum of the private equity industry, from the smallest venture capital to the largest buyout funds as well as the investors in the asset class. The private equity business model is at its core extremely simple. By setting long-term and closed-ended funds, the managers we represent allow institutional investors - such as pension funds, banks and insurers - but also sophisticated ones - such as high net worth individuals or family offices - to commit capital to businesses at different stages of their growth. Private equity managers do not only provide equity investment but also get actively involved in the running of the businesses the fund has committed capital to.

For venture capital, this "active ownership" is about transforming bright ideas into operational businesses that can scale-up, with the ultimate objective to create new sectors of the European economy. For the larger end of the private equity market, this can range from helping infrastructure companies build new facilities or assisting businesses in sectors as diverse as consumer goods, ICT or healthcare to expand to new markets or to overcome difficult situations. In all these situations, the core purpose of the private equity ownership is to strengthen management expertise and to deliver operational improvements that will help the company expand into new markets.

Private equity in numbers

Over the past five years private equity managers invested on average over 75bn EUR into 6,000 companies, a large majority (84% in 2019) of which are SMEs[1]. Over the last decade more than 550 billion EUR has been invested into 35,689 businesses, with more than 8 million people in Europe working in a private equity backed business. With the support of investors these businesses are more innovative, productive and resilient than their peers with other types of owner. This contributes to higher growth and job creation.

While private equity fund managers fall under the general term of "alternative investment firms" and are regulated as such under the AIFMD, they have **very different characteristics from other types of AIFs**. They do not offer redemption rights for investors (and therefore pose little liquidity risks), they predominantly invest in unlisted securities (their investments are not directly affected by market movements) and they do not generally need to deal or take management decisions on a short term or day to day basis. These characteristics affect the managers' risk profile and distinguish the asset class from other, more liquid, ones.

The private equity industry is also **intrinsically cross-border**, with funds being raised from investors across Europe and the rest of the world and invested by managers in portfolio companies in Europe and beyond. Free movement of capital on a global basis (both into and out of the EU) is important both for portfolio companies, which are the recipients of third country private equity investment, and for European institutional investors, who invest in third country private equity funds as part of

[1] All data on the private equity industry is from Investing in Europe: Private Equity activity 2019.

their asset allocation and risk diversification strategies. This is especially true post-Brexit as a significant part of the industry is based in the United Kingdom.

Our general views on the proposed priorities

Our intimate conviction is that the CMU project should not so much be about capital markets than about finding additional ways to transform European savings into investments in growing businesses.

For this reason, CMU initiatives should not so much be about addressing the needs of the various corners of the financial industry than about promoting access to the markets for investors.

Placing the treatment of long-term equity at the heart of the CMU is much welcomed from that perspective. Initiatives recently presented by the High Level Forum to the European Commission - such as targeted changes to the ELTIF regime, more appropriate calibration of institutional investors' equity risk weights or easing specific investors access to EU markets. These measures all could ensure that capital can flow, either directly or indirectly, from investors to companies, in a form that is of most use to the latter and of least risk to the former.

Nonetheless, and perhaps due to the composition of the Forum, several of the workstreams presented in the HLF Report, such as the one on securitization, demonstrate that the **over-reliance to the banking system** is sometimes as much psychological as economical. While banks obviously have a key role to play, as investors and as intermediaries, our view is that the CMU project should focus as much as possible on those areas that can truly benefit equity markets, as opposed to make them more dependent to bank financing.

It is perhaps a flaw of the CMU model as presented so far that it has **too much focused on the needs of intermediaries as opposed to the actual needs of businesses** that these intermediaries support or the investors they provide revenues to. We believe that the next iteration of the CMU programme presents a unique opportunity to start from the angle of the businesses whose success is most crucial to the European economy and of the investors who have so far been prevented from accessing capital markets, either out of lack of knowledge or for fear of the consequences.

Our suggested recommendations

1. Improving the status of European Long-term Investment Funds (ELTIFs)

Context

The private equity industry supported at the time the creation of ELTIF as a new product and brand, as we saw it as an opportunity to encourage investors to commit their capital for the long term.

> ***In numbers:*** *Private equity is by all means a long-term investment. A typical, closed-ended, fund is set up for a period of 10 years, which is usually extended by two years. Meanwhile, the average length of an investment into businesses (the "holding period") is around 5.7 years for venture and 5.8 years for buy-out funds. This allows fund managers more than sufficient time to deploy their "active ownership" model.*

However, ELTIF, as a retail product, was not necessarily seen as of relevance to most private equity and venture capital funds as these are mostly marketing to sophisticated individuals (see our comments on Recommendation 13). Opening the asset class to new types of investors, provided its requirements are carefully balanced, may however be an option in the future.

Our suggestions

As the members of the High Level Forum, we do not believe that the ELTIF Regulation is broken, but that targeted refinements could make the regime a more powerful instrument in assisting Europe's economic recovery amidst the Covid-19 crisis.

1) Incentives

Attaching incentives to the use of the product and to long-term investments more generally will go a long way in making ELTIF a more attractive vehicle. **Prudential requirements** appropriate to their long-term equity investment horizon are naturally a key incentive. While measures have already been taken in that regard in Solvency II (see Recommendation 3), **changes of the same nature could also be introduced to the banking framework** to ensure no institutional investor is disincentivised to invest in a ELTIF due to the long-term nature of the product. Granting a **favourable tax treatment** to ELTIFs (no tax on dividends or capital gains) across EU jurisdictions would also help boosting their attractiveness.

2) Managers' eligibility

If ELTIFs were conceived as a financial instrument to address the lack of late-stage venture capital financing, as claimed by the HLF, an obvious flaw of the regime in place is that **it does not allow fund managers marketing their funds under the EuVECA passport to become ELTIF managers**. Most venture capital managers prefer using the EuVECA passport than to opt-in to the onerous AIFMD requirements due their size. An extension to managers of EuVECA funds would allow smaller funds who are outside the scope of the AIFMD – but whose fund structure is regulated at EU level – to offer this product.

3) *Eligible investments*

ELTIFs should have the option to be diversified into a fund of funds by increasing the limit on investing in other ELTIFs, EuVECAs and EuSEFs to 100% in Article 12 of the Regulation. We also agree with several of the recommendations of the High Level Forum to **clarify some of the key concepts of what are eligible investments**, such as investments in "real assets", the concept of "benefitting the European economy" or what is the minimum proportion to be invested in EU Member States. However, widening the scope of ELTIF too much could dilute the value of the brand.

2. Appropriately capturing the risk of insurers' investments in long-term funds

Context: The Solvency II model, based on volatility, **makes long-term illiquid equities less attractive for insurers**, as it relies on the assumption, irrational from an economic perspective, that an insurer will sell long-term equities, even under times of market stress, in the same way it would sell daily tradable securities.

> ***In numbers:*** *The Solvency II Directive made long-term equity investments less attractive and contributed to a global trend of withdrawal from this asset class by insurers. According to EIOPA, only 0,6% of insurers' investments are currently made in private 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- despite insurers' investment portfolio assets representing 58% of the EU GDP[3]. An increase of insurers' investments in private equity by only 1% (to 1,6% of the total invested by insurers) could represent an additional investment of €10 billion per year into the asset class, bridging the gap with pension funds investments.*

The creation of the long-term equity (LTE) category (Article 171a of Solvency II Delegated Acts) was the best route to increase 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. While it is essential for long-term portfolios to meet a series of relevant criteria proving they are held for the long-term, tailoring the category's criteria is the way forward to ensure a proper risk treatment of long-term insurance equity investments.

Our suggestions: a series of amendments could be introduced to Article 171a of the Delegated Regulation to make requirements more practical:

1) Simplify the asset-liability management (ALM) requirements

An option to simplify the existing framework would be to **allow portfolios solely composed of exposures to closed-ended funds to be eligible** without having to comply with the cumbersome list of criteria. An investment in a closed-ended fund would be deemed long-term provided the life of these funds, set in their mandate, is longer than five years. This logical step would provide for an explicit recognition of the long-term nature of non-redeemable equities held within unlisted funds, making it much easier for the insurers to set up these portfolios.

2) Expand the geographic conditions

We would propose to align the geographic criteria to the other existing ones within the equity risk exposure sub-section in order to, at least, **cover all OECD markets**.

3) 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 Solvency II framework. 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[4] should also be considered. Even small portfolios of funds are sufficiently diversified to receive the 22% risk weight and no additional diversity criteria should therefore be necessary for these portfolios.

---

[2] EIOPA European Insurance Overview, 2018

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

[4] All of which being fundamental considerations taken into account by any insurance firm investing in unlisted equities via private equity funds

3. Allowing banks to invest in equity funds

Context

Supporting SMEs in need of financing is arguably one of the most crucial role banks can play. While all businesses are drivers of the European economy, start-ups and scale-ups play a particularly vital role in creating new jobs and enhancing Europe's competitiveness. Credit institutions should also have the ability to support these businesses when these are backed by venture capital, growth and private equity funds. Recent changes to the CRR capital requirements have been at odds with the overall policy objective to support venture capital. An incorrect assessment of the risk of investing in closed-ended funds will limit the amount of funding available to innovative businesses[5] and deprive banks from achieving the returns they need in a low yield environment by investing in a diversified range of asset classes.

> ***In numbers****: Until 2009, banks represented around 12% of the overall investment in venture capital funds. However, over the past few years, that number was down on average to 4.5%. With the upcoming substantial increase of equity exposures risk weights,* ***banks may find it less interesting to finance****, through long-term equity funds,* ***businesses*** *that could provide answers to current economic and ecological challenges, such as the low growth rates and the green transition. Before 2009, pension funds invested twice as much in the entire private equity asset class as banks - over that past 10 years, the gap has increased to* ***six times****. If the increase in bank allocation had matched that of pension funds, banks would have committed an additional €15 billion capital into businesses through private equity in 2019 only.*

Our suggestions

The current wording of Article 128 CRR and the categorisation of to **"investments in private equity" or "investments in venture capital firms" as high risk exposures** is inappropriate**.** While we are not opposed to the principle that some types of exposures should be subject to a higher risk weight due to their nature, we **fundamentally disagree with the notion that this should be the case of banks' equity commitments to businesses through "private equity" and "venture capital" funds**[6].

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. 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.

From our perspective, there has never been any clear economic rationale to why "investments in private equity" and "investments in venture capital firms" should be differentiated by nature from other equities, considered "high risk" and receive a 400% risk weight. We believe that qualifying underlying exposures in a private equity or venture capital funds' exposures as high risk is always inappropriate because:

- it does not take into account the role that fund diversification plays in reducing the overall risk of the investors' exposure
- it overestimates the risk of failure of private equity-backed companies (compared to, for example, listed companies).

We fully support the view of the High Level Forum that the 400% risk-weighting should only apply to investments which are genuinely "speculative" and "intended for short term resale" (based on the definition given by the EBA in its recent Guidance on high risk exposures). Meanwhile, we call for

[5] See for example the conclusion of this recent ECB Report on Access to finance for SMEs

[6] The very reference to "investments in venture capital firms" to designate investment in portfolio companies in itself demonstrates great confusion in the existing Basel approach as to what is such an investment.

policymakers to introduce a similar ***long-term equity category*** in CRR subject to a lower risk weight under defined conditions.

4. A new treatment for knowledgeable and sophisticated investors

Context

Most capital committed to our asset class comes from institutional ones (such as banks, pension funds or insurers). Given the length of the investments (on average 10 years) and the lack of redemption rights/limited secondary markets, very little "pure retail" investors access our asset class (in case they do, it will then be through specific and usually listed vehicles). However, private equity funds will also admit as investors a number of **high-net worth and/or sophisticated individuals**. These always have **extensive industry or sector experience** (for example in an operational role or as an entrepreneur) that provides them with a sophisticated understanding of the specific investment into a fund that they are intending to make. Despite this, these are by default "retail investors" under Annex II of MiFID II.

> ***In numbers:*** *Today, private equity investors that are not automatically classified as professionals account for around 20% of the overall private equity fundraising (incl. venture capital) and around 40% of the venture capital fundraising. However, the €1 billion committed on average every year to venture capital funds represents a tiny proportion (less than 0.01%) of the around €13 trillion of net investable assets held by European high net worth individuals[7]. There is therefore a significant scope for improvement.*

Most problematically, many of these do not even satisfy the existing "elective professional investors" tests. The first elective test (frequency) is calibrated for participants in liquid markets such as those for exchange-traded equities. It is inherently discriminatory for some clients due to the long-term and illiquid nature of private equity funds[8]. Even with an equal level of sophistication, this puts these clients investing over the long-term at a significant disadvantage.

Our suggestions: redefining the MiFID categorization of investors, and the elective test, is an essential step to cater to all asset classes' specificities. We would suggest at least:

1) adding a separate "frequency "criterion for long-term transactions

The number of relevant transactions to be deemed "sophisticated" should not be as high for long-term investments, where there is a significantly lower transaction frequency due to the typical size of deals, than for daily trading activities. To determine the relevant minimum commitment that would allow an investor to be eligible to a lower frequency, the **€100,000** threshold, defining "sophisticated investors" in Article 6 of EuVECA (Regulation (EU) No 345/2013) and excluding offers from the prospectus obligation in Article 1.3 (c) Prospectus Regulation, would be most appropriate.

2) Modify the wealth criterion

We agree with the view that the existing "wealth" threshold of EUR 500,000 could be lowered without necessarily reducing investor protection. In addition to lowering the amount, it might be worth considering an alternative threshold referring to the **person's total net worth** (excluding main home)[9].

---

[7] EY study on Wealth Management Outlook, 2018

[8] In a private equity context, not even the most seasoned institutional investors make as many as 10 commitments per quarter to private equity funds. These investors will typically build portfolios of say 20-40 private equity fund managers over a number of years in order to spread vintages and manage cash-flows.

[9] While experienced investors (e.g. owner-managers of privately held businesses, serial entrepreneurs or business angels) will have a high net-worth, in some cases a big part of this will not be held in cash deposits and/or financial instruments (but rather, for example, in unit-linked insurance contracts).

Alternatives to the review of the definition would be targeted extension of number of individuals a firm can market to under sectorial legislation (such as AIFMD) and the clarification of the KID-PRIIPS scope (to exempt sophisticated individuals from requirements not suited to their needs).