April 2021

Improving the prudential frameworks for banks and insurers

The private equity perspective in 6 questions

1. What is private equity?

Invest Europe is the association representing the European private equity and venture capital fund industry (hereby referred as "private equity"), from small venture capital shops to large buy-out firms, including turnaround and infrastructure capital.

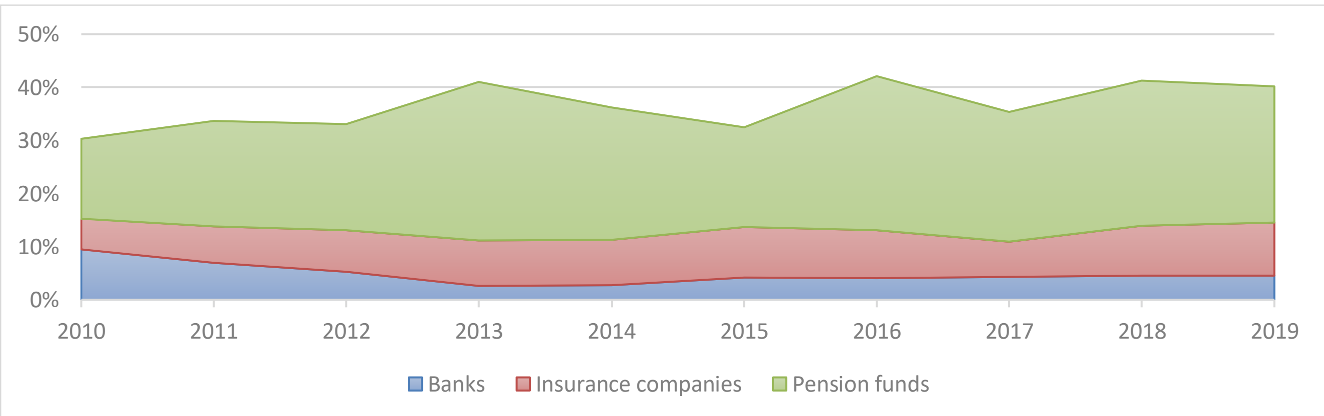
Private equity manager raise capital from investors looking for long-term yield in order to set up long-term (typically 10 years), illiquid, closed-ended and unleveraged funds, which cannot be regularly traded. Investors become "limited partners" of these funds. With the capital collected, managers will make direct and active investments into 10 to 20 businesses for an average of 5-6 years. Once invested companies have grown or improved, managers will either sell the company or introduce in the stock market through an IPO. Profits made are then returned to the investors towards the end of the fund's life.

For more details on how private equity functions, please look at our briefing paper "The Good, the Hedge and the UCITS".

2. Why are Solvency II and CRD/CRR relevant for private equity ?

Both prudential frameworks determine the risk charges that are attached to committing capital into a private equity fund.

By imposing these investors to hold a certain amount of capital before investing into these funds, they naturally have a major impact on the attractiveness of the asset class. This is especially true as private equity is nearly exclusively offered to institutional investors, such as pension funds, insurance companies or banks. Despite similar characteristics, pension funds (which are not subject to capital requirements) have increasingly become a much more relevant source of capital for private equity funds than banks and insurers.



Graph 1: Share of private equity overall fundraising (Invest Europe/PEREP, 2020)

3. Why is private equity relevant for banks and insurers?

In the current low interest rates environment, both banks and insurers are facing increased pressure to provide returns to their clients. Investing a (very) small part of their assets into alternative funds allows them to both access better rates of returns and give them a higher level of diversification.

From that perspective, private equity, an asset class generally outperforming public markets, is an increasingly attractive choice. **European** buy-outs delivered a net IRR of 15.00% versus 5.84% for the MSCI Europe. **European** growth funds' net IRR is at 13.28%, while **European** venture capital is at 9.77% IRR.

Graph 2: Compared Net IRR (Invest Europe, The Performance of Private equity, 2019)

Overall, access to the private equity class allows large institutional investors to indirectly finance parts of the European economy – such as start-ups or scale-ups – without the risk of investing directly into businesses at a growing or turning stage of their life, thanks to the safety cushion of fund diversification.

4. Do Solvency II and CRR appropriately calibrate the features and risk of investing in private equity?

No.

Solvency II assesses the risk of investing in equities based on the sensitivity to the volatility of equity markets, a model that is much less relevant for long-term commitments with no redemption rights (Article 168 Solvency II DA). It also invariably "look-through" to the underlying equity, without consideration to the diversification benefits of investing in a fund portfolio (despite such diversification being at the core the private equity model).

> ***Article 105 Solvency II, para 5***
> *"The market risk module shall reflect the risk arising from the level or volatility of market prices of financial instruments which have an impact upon the value of the assets and liabilities of the undertaking. It shall properly reflect the structural mismatch between assets and liabilities, in particular with respect to the duration thereof. It shall be calculated, in accordance with point (4) of Annex IV, as a combination of the capital requirements for at least the following sub- modules:*
> *[…]*
> *(b) the sensitivity of the values of assets, liabilities and financial instruments to changes in the level or in the volatility of market prices of equities (equity risk)"*

> *Article 128 CRR, para 2*
>
> *" Institutions shall treat any of the following exposures as exposures associated with particularly high risks:*
>
> *a) investments in venture capital firms, except where those investments are treated in accordance with Article 132;*
> *b) investments in private equity, except where those investments are treated in accordance with Article 132;*
> *c) speculative immovable property financing."*

CRD/CRR considers that "investments in private equity and venture capital firms" are necessarily speculative investments (Art 128 CRR). Even if the EBA confirmed this was meant to cover direct investment only, the use of the look-through means that 10-year, diversified exposures to private equity funds are considered in the same way as speculative day-trading.

5. Is this a priority?

Yes. Action 4 of the European Commission Action Plan is all about reconsidering the prudential treatment of long-term equity:

> *"The Commission will seek to remove regulatory obstacles for insurance companies to invest long-term, without harming financial stability and policyholder protection. It will also seek to provide for an appropriate prudential treatment of long-term SME equity investment by banks"*

Moreover, the CMU High Level Forum also flagged specifically the issues posed by the wording of Article 128 CRR.

6. How can the upcoming reviews improve the current situation?

For insurers…

Over the past few years, laudable efforts have been made to give long-term equity exposures their own category (Article 171a Solvency II DA). Unfortunately, criteria attached to this category are still hard to meet in practice, despite growing interest of the insurers for using this category for their investments in private equity and infrastructure.

In a detailed position paper, we suggest introducing changes to Article 171a of the Solvency II Delegated Regulation for the criteria attached to the use of the long-term equity category to be easier to meet, taking into consideration that this category is an absolutely necessary "safe haven" to appropriately assess the actual risk of these exposures. Main changes relate to

- simplification the asset-liability management (ALM) requirements
- broader geographic conditions
- better consideration of the diversified nature of these portfolios

We also invite policymakers to consult the views of the insurance industry (Section 2.8, p.17).

For banks…

The upcoming CRD/CRR review offers the opportunity to remove references made to private equity and venture capital in Article 128 CRR and to replace it with wording that is more coherent with the nature of the industry and with the objectives set in the Basel III framework.

Meanwhile, effort should be made, as in the Solvency II framework, to allow long-term equity investors to receive their own risk weights provided portfolios meet a series of conditions (i.e. : asset liability management requirements). If not, consideration should at least be given to the difficulties investors in unlisted equity will face to meet the criteria of the mandate-based approach – which requires daily price quotes that are not available to these illiquid funds.

These views are detailed in a specific position paper.

How to contact us ?

If you believe, as we do, relevant changes to the prudential frameworks would contribute to building a Capital Markets Union and help the financing of businesses through additional channels, we are at your disposal to discuss these issues further.

For more details, you can contact Martin Bresson (martin.bresson@investeurope.eu) or Christophe Verboomen (christophe.verboomen@investeurope.eu) at Invest Europe.

About Invest Europe

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors. 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.