

Use of debt and leverage reporting

High-level principles for Invest Europe members

Introduction

Recent market developments have seen increased interest in - and use of - debt instruments across private equity structures. This notably includes the use of **NAV facilities** as a way to provide additional liquidity.

At the same time, **supervisors across the EU are paying closer attention to the use of leverage**, its measurement, and its reporting under existing legislative frameworks. This is especially true in light of recent media reports, however misguided, on the US private credit market.

Against this backdrop, Invest Europe considers it useful to share with the membership some high-level principles to ensure its members are **aware of the potential implications of the quality of their reporting on their use of leverage**, both **at firm level** (as it could lead to regulatory sanctions) and **at industry level** (as it could reinforce a perception that our industry is not properly disclosing the risks it poses).

Importantly, this note is **not intended to set a single standard or interpretation** beyond what is required by law in different European jurisdictions, nor does it imply there are currently reporting issues in the market. It should only be seen as a signal from Invest Europe to its members, as leverage rules are complex and require caution.

High level principles

Principle 1: Using debt can have an impact on the fund's regulatory status

EU fund legislation requires managers to **identify, assess and appropriately report leverage**, where relevant. In some situations, the use of leverage may also trigger additional regulatory requirements. In the EU and the UK, the use of leverage at fund level currently determines the applicable AIFMD authorisation threshold, the imposition of specific liquidity and leverage rules, and the prudential treatment of insurers' investments in the fund.

Principle 2: Not all uses of debt are considered leverage (and lead to regulatory obligations)

Lawmakers across Europe recognise that **debt incurred at portfolio company level in a typical leveraged buyout structure does not, in itself, constitute leverage of the fund.**

Based on existing case law, the relevant elements to justify why debt at portfolio company level is not creating a risk for the rest of the fund are:

- the debt held by each of its individual portfolio companies is ring-fenced from any debt of the fund itself and of any other portfolio company controlled by the fund.
- the bank has recourse to the underlying company only when private equity managers use a holding company for an acquisition.
- the fund's maximum possible loss is restricted to the amount of equity it invested in the holding company.

This exemption is currently enshrined in EU law for private equity deals but nonetheless occasionally challenged by regulators. **Contact us if you have had concerns with your regulator on this.**

Principle 3: NAV facilities may or may not be considered to be fund leverage (and lead to regulatory obligations) depending on specific situations

While the same underlying principles will be relevant to NAV facilities, these have specific features that mean the “buyout debt exemption” **may or may not apply**, depending on the structure and the facts of each case (including issues such as recourse, security, duration, and proximity to the fund level).

Ultimately, any assessment of whether the use of a NAV facility means a fund becomes leveraged should be made by **an expert fund advisor with an intimate knowledge of the implications of the deal.** We strongly advise Invest Europe members to make this assessment given the risks of inappropriate reporting.

Principle 4: Managers should factor the political environment in their thinking

Managers should be aware that regulators are increasingly seeing NAV facilities from a financial stability perspective.

When reporting these facilities, managers and their advisors should be aware that regulators may take stricter positions in the coming months and years than they have so far taken, in light of increasing concerns about the use of debt in the private capital asset classes.

Conclusion

In the current context of increased regulator's oversight on the use of debt by private fund managers, members that have not already done so are therefore **strongly encouraged to seek appropriate legal advice** when using, or contemplating the use of, fund-level borrowing or NAV facilities, particularly where the regulatory classification is not straightforward.