"Which framework of prudential supervision to favor long-term investment?"

Intergroup on Sustainable, Long-Term Investments & Competitive European Industry

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CHECK AGAINST DELIVERY

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Thank you for inviting me to this event.

Let me explain what is the relationship between banks and private equity managers our association represents. And let me clarify that, when I mean private equity, I include all types of fund managers, from the owners of the smallest venture funds to the largest buyout and infrastructure houses.

On one hand, the private equity fund manager finds in banks a solid and long-term investor into the 10-year closed-ended fund it sets up. On the other hand, credit institutions see in private equity funds an opportunity to commit long-term equity into a diversified portfolio and have indirect exposures to 10 to 15 businesses. In other words, this is a very virtuous relationship for both ends, both from a yield and risk perspective.

And yet it is a relationship in danger. From 2007 to 2011, banks represented around 12% of the overall investment in private equity funds. However, since then, that number was down on average to 5% according to the latest Invest Europe Private Equity Activity Report.

In 2020, banks already invested half as much as insurers and six times less than pension funds in the asset class. If banks were to invest in the asset class *at par* with the pension fund industry (based on commitments made over the last five years), they could have contributed to an additional €19 billion euros per year to finance the European economy. And this with the diversification benefits fund investments entail.

So, what is the problem? There are many reasons why banks enjoy a comparatively worse relationship with private equity than other institutional investors, some that are just market related. But it's clear than one of them is Basel rules – and the CRD/CRR framework that implements them into EU law.

From that perspective, the proposal introduced by the European Commission last month is quite concerning. It is worrisome because it will further <u>disincentivise</u> rather than incentivise investments in long-term funds such as private equity. Indeed, it will both increase the risk-weights for equity investments under the standardised approach while making it impossible for banks to use the internal model for their equity exposures.

Today the EU framework no longer recognises any benefits of investing over the long-term and of investing in diversified funds. This is of course hindering the role banks may play, as Capital markets Union players, in financing the European economy. There is no question the CRR is a step back when it comes to the CMU.

But, most importantly, this is as much as prudential problem than a political problem. Let me tell you why. As long as diversification benefits are not accounted for - as they are in Solvency II for example - then it will be more interesting economically, i.e., less costly, for banks to have direct exposures to short-term assets. The outcome is therefore that banks will be more likely to have less diversified, more short-term, and therefore riskier portfolios.

If the EU policymakers' goal is for banks to drive long-term growth, it is essential to:

- First, grant long-term funds a preferential risk treatment

This would both recognise the positive impact it would have on the European ecosystem and the lower risk these investments represent. It is not sufficient to consider that long-term exposures are not speculative exposures – long-term exposures should have a better treatment than typical equity holdings – as they have in Solvency II.

- Second, EU policymakers should grant investments in long-term, diversified funds a risk weight that is more suited to their characteristics

It is not logical for CRR to not account for risk diversification at fund level despite the extensive economic literature showing that this type of investments is much less risky than direct ones.

Let me end by some good news: these changes are not complex to make. And the time is perfect to implement them. So, if we have a message to give, it is for EU policymakers to not hesitate to pick this low hanging fruit.