On behalf of the Public Affairs Executive of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

Response to the European Banking Authority Consultation on its CRR Guidelines on specification of types of exposures to be associated with high risk

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July 2018

The European private equity industry[1] welcomes the opportunity to provide comments on the European Banking Authority (EBA)'s draft Guidelines on specification of types of exposures to be associated with high risk under Article 128 (3) of the Regulation EU/575/2013.

The comments provided in this response solely focus on the first section of the EBA draft Guidelines that aims at clarifying the notion of "investments in venture capital firms" and "investments in private equity". We therefore only provided an answer to Question 1.

Question 1: Do you agree with the proposed clarifications in paragraphs 2 and 3? Would you like to bring forward arguments which potentially mitigate the caveats of the alternative approach for defining what constitutes an investment in private equity?

Introduction

We recognise that Article 128 paragraph 2 of CRR contains provisions that refer to "investments in private equity" and "investment in venture capital firms" and that these terms are not defined in CRR or in any other piece of EU law. As a result, there is a potential risk that this can create some degree of uncertainty.

However, we have several concerns regarding the EBA proposed approach and we fear that the section of the EBA guidelines (paragraphs 2 and 3) which defines the concepts of "investments in private equity" or "investments in venture capital firms" could create more confusion than clarity. It is in particular unclear whether the EBA proposed definition intends to cover only *direct* equity exposures (i.e. those cases in which banks acquire an equity stake directly in a non-listed company) or whether it covers all types of exposures – including those made through funds. It is our understanding however that the EBA Single Rulebook Q&A[2] already indicates that points (a) and (c) of the second paragraph of Article 128 CRR do not cover funds' exposures.

We also believe that it is unfortunate that the consultation paper does not provide any evidence of a compelling need to issue new guidance or any information explaining why the EBA has

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[1] The term private equity refers to both private equity and venture capital. Where there are specific characteristics relating to the venture capital industry only, we use the term venture capital.

[2] Question 2013_374

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concluded that such clarification is needed now, in particular given that it acknowledges that Article 128 of CRR is currently being reviewed as part of the ongoing CRD/CRR negotiations. While there are some differences between the co-legislators' approach on this issue, the final version of the CRR Regulation that emerges from this process may delete any specific reference to these exposures. Both definitions that the EBA is proposing could become irrelevant to CRR implementation shortly after the publication of the Guidelines.

Furthermore, we note the specific treatment of "investments in private equity" originates in the Basel II rules and was based on Basel Committee analyses conducted as early as in 2001. Such approach has therefore been in place for a long time, including under the Capital Adequacy Directive, and our understanding is that the absence of a definition has not caused any issue during that period, either to the banks or to national competent authorities. Moreover, Basel rules III (agreed in December 2017) encompass further adjustments to the Standard Approach, which will have to be transposed in the EU banking framework.

Private equity exposures under CRR rules

The term "private equity", which encompasses equity share capital not listed on public exchanges, can be used to refer to fundamentally different types of exposures:

- **Direct investments in private companies**. This is where the ultimate investor acquires a proportion of the equity of a private company. These stakes would be held for future sale, with the duration of the holding period largely at the discretion of the investor.
- **Private equity funds**. In this instance, the ultimate investor invests in funds managed by a specialist professional fund manager. The latter will combine such monies from multiple institutions. The fund manager will use these monies to invest in or acquire private companies, with the fund manager generally exercising a degree of management control, or at least influence. The fund manager will construct a portfolio of such investments. These would typically be held for several years, with the ultimate goal being the sale of these investments (the divestment process), which in turn provides the capital to distribute cash back to the funds' investors.

It is worth noting that those two types of exposures do not at all bear the same risk, have different characteristics and are treated differently by banks, as is explained in the Annex I and II to this response.

As currently applicable, the Capital Requirements Regulation (EU/575/2013) allows the exposures in the form of units/shares in CIUs to be treated either under Article 132 or Article 128 (items associated with particularly high risk). This means that the scope of Article 128 would cover both equity investments held directly by the bank as well as investments held through an AIF. This is clearly the case for exposures listed in point (b) of paragraph 2 of the Article.

There is nonetheless already **existing guidance** clarifying the current treatment of private equity fund exposures. According to the response to Question 2013_374 in the CRR Q&A, published by the EBA on behalf of the European Commission, "*for the definition of exposures in the form of shares in a CIU or units in a CIU, it is clear these are not the same as "investments in private equity"*".

The Q&A further explains that, while some exposures in the form of shares in CIUs can be associated with high risk, it is either because the fund falls under Article 128(2)(b) or because, as in the case of private equity funds, the "*underlying exposures of the CIU*" are explicitly considered as being associated with high risk. We believe this clearly indicates that it is the bank's direct investment that is covered in either point (a) and point (c) of the second paragraph.

Moreover, the general context and the **current review of the CRD/CRR** suggest that the actual intention of co-legislators was to cover investments through funds (other than those referred to Article 128(2)(b)) as part of Article 132. We believe that this intention is clearly confirmed in the Commission's Explanatory memorandum to the CRD/CRR review, which states that "*Article 128 is amended to ensure the definition of items associated with particularly high risk does not capture exposures in the form of units or shares in CIUs*".

In our view also the Council General Approach on the CRD/CRR review, as agreed in May of this year, aims to clarify that all investments through CIUs should not fall within the scope of Article 128.

In light of the above, we are concerned that the EBA Guidelines could have the exact opposite effect of *both* the technical explanation given by the Commission in Question 2013_374, *and* the political intention of the co-legislators, and reinforce uncertainty instead of clarifying it. As currently drafted, it could indeed lead to a situation where exposures to investments in private equity *funds* could potentially be subject to the 150% "high risk" risk-weight despite the clarification provided by the European Commission in the EBA Single Rulebook Q&A and the obvious intention of co-legislators to cover these as part of Article 132 of CRR.

Given that credit institutions which are making investments in private equity typically have teams focusing solely on such investments and that are well aware of what a private equity investment is, we believe that the section of the EBA guidelines which defines these two concepts is unnecessary.

We would encourage the EBA to reconsider its approach and not to propose any definition of "investments in private equity" and "investments in venture capital firms".

Should the EBA nonetheless proceed to offer a definition, the Guidelines should make clear that they only cover *direct* private equity investments and that investments through *funds* are subject to the risk-weights under Article 132 or, if relevant, point (b) of paragraph 2 of Article 128. This would avoid the uncertainty and confusion that we described earlier in this response and also ensure consistency with the existing guidance of the Commission.

Unworkability of the proposed definitions in the context of private equity exposure through funds

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If, irrespective of our arguments above, the EBA were to propose definitions of “investments in private equity” and “investments in venture capital firms” that could capture both direct and indirect exposures (understood as exposures through funds) we feel the EBA should review its proposed definitions in order to make sure they accurately reflect the nature of these investments and the way they are understood within the financial services industry.

Both definitions set out in paragraphs 2 and 3 of its proposed Guidelines (section 4.1 of the Consultation paper) seem to be based on the existing definition of “equity exposures” in Article 86 paragraph 2 of CRD, which the EBA amended by adding a reference to the fact these exposures are not listed on an exchange (point (a) of the definition). The proposed definition also refers to certain reasons why such investments may be held (point (b) of the definition).

While we have some concerns regarding point (a) (e.g.: lack of clarity regarding the references to “subordinated, residual claims” and to exposures “the economic substance of which is similar to [non-debt exposures]”; issues related to the fact that some relevant exposures may be listed on an exchange), our comments are here concentrated on point (b) which presents the reasons for holding each type of investment.

For “investment in venture capital firms”, the EBA suggests their key characteristic is that they are held “with the objective of providing funding to newly established enterprises”. For “investments in private equity”, they are held “with the objective of generating a profit through various means (including a leveraged buy-out, an IPO or the sale of an equity stake)”.

We do not believe that the intention behind the holding of such investments is the most appropriate criterion to define these investments and is not an accurate reflection of the difference between what constitutes “investments in venture capital firms” and “investments in private equity”.

Indeed, venture capital firms also invest in companies with the ultimate objective of generating a profit for their investors, and private equity investments are often made with the purpose of developing new products and related research for an enterprise. As a result, the two definitions could very well cover both “investments in private equity” and “investments in venture capital firms” simultaneously.

In light of this, we would rather suggest that the EBA base this definition on the types of transactions that are made (e.g.: management buy-in, public to private transaction (P2P); provision of seed, start-up, development or growth capital to an undertaking*)* and for the EBA to ultimately only capture exposures that arise as a direct result of such transactions. This would add legal clarity and more closely mirror the way “private equity” has been understood by the industry and equally policymakers over the past few years.

Furthermore, we would suggest that for the purposes of its Guidelines the EBA should only present one single definition of “investments in private equity” and “investments in venture capital firms” for the reasons explained below:

1) as demonstrated above, these business models do not differ, either from an operational or risk perspective (from an industry perspective, venture capital is indeed considered as a "subset" of the private equity industry)
2) it will often happen that private equity funds will have mandates which permit them to make both types of investments (e.g.: a "generalist" fund manager will sometimes have one fund labelled as "venture capital" and one as "buy-out").

As a result, we believe that it is unnecessary - and unhelpful - to distinguish between private equity and venture capital exposures for the purposes of the Guidelines. It therefore makes more sense to define investments in private equity and venture capital firms in a wider, general definition covering both point (a) and (c) of paragraph 2 of Article 128 CRR.

Conclusion

Taking into account the fact that banks, as professional investors, are already well aware of what constitutes investments in private equity, that Article 128 is currently under review, and that the introduction of the proposed definitions could ultimately create confusion as to what is private equity both in a CRR and in a broader context, we would encourage the EBA to reconsider its suggestion and not to propose any definition of "investments in private equity" and "investments in venture capital firms" in its final Guidelines. We remain of the view that the proposed definitions are not necessary and could have unintended negative implications without bringing any benefits from a risk perspective.

However, if the EBA considers that such definitions should be put forward, despite the comments made in this response, we believe that the EBA should clarify that these definitions apply only to banks' *direct* investments for the reasons explained earlier in this response. Though, if the intention of the EBA is to capture both direct and indirect exposures to private equity, which would not be in line with the intentions of the co-legislators in our view, the EBA should review its proposed definition to take into account several characteristics of what constitutes private equity investments, in particular investments through funds.

We stand at the EBA's disposal to provide any further information to ensure that the EBA guidelines do not have any adverse consequences for banks' ability to invest in private equity funds and the way it might be defined in other pieces of EU law.

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Annex I: Main characteristics of the private equity industry

The private equity industry has a specific structure, business model and investment characteristics that differentiates it from other forms of asset management. The main objective of private equity funds is to help build sustainable businesses by making long-term – on average six years - equity investments and by actively managing these investments through the contribution of human capital to the business. As such, private equity funds play an important role in delivering economic growth that creates jobs and enhances the long-term competitiveness of the markets they are active in. Overall, they provide long-term financing for more than 5,000 European businesses each year, 86% of whom are SMEs, employing around 8 million people.

While private equity fund managers fall under the general term of "alternative investment funds (AIFs)" and are regulated as such under the AIFMD, they have very different characteristics from other types of AIFs. They typically only market to sophisticated and professional investors, 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 their risk profile and distinguish them from other asset classes.

i. Private equity funds are typically structured as **closed-end vehicles in which investors do not have early redemption or withdrawal rights**

Private equity is a long-term investment, which takes time to mature. Fund structures in private equity and the structure of the banking teams investing in it have been specifically designed to reflect this long-term characteristic. Private equity investments are not designed to be traded like a liquid asset. Investors cannot withdraw during the life of the fund, as is expressly excluded by the legal agreements at the heart of the fund. As explained below, funds are usually structured to have a minimum life-span of 10 years to ensure that the underlying companies in which investments are made have the time and potential to grow and develop further.

ii. Private equity funds typically **do not employ leverage at the level of the fund**[3] and are legally not permitted (through their constitutional documents) to be leveraged

It was mentioned during the hearing held by the EBA on 4 May 2018 that one of the elements leading the EBA to consider private equity investments as risky was "its level of leverage". However, private equity funds are not typically leveraged and do not use leverage at the level of the fund in the traditional sense (i.e. they do not use borrowings to increase the amount available to the fund for investment). In other words, private equity funds are not engaged in any activities that would magnify their investors' exposure to other market participants and put the investors in situations where they would not be able to meet their contractually -agreed commitments to the fund. While the funds may sometimes be able to make use of a short-term borrowing facility, or have the ability to use derivatives to hedge the risk of their foreign currency exposures, these activities will systematically be backed by undrawn commitments.

[3] Under the relevant EU sectorial legislation leverage means "any method by which the AIFM increases the exposure of an AIF it manages" (Article 4 paragraph 1 (v) of AIFMD)

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iii. Investments in private equity funds allow for **diversification**

Institutional investors will gain exposure to investing in a portfolio of private equity funds, which is diversified, by vintage year, geography and stage of investment from early stage venture capital and growth equity, up to larger buyout funds. This largely mitigates the overall risk of the fund portfolio.

Despite this, little consideration has so far been given to the substantial risk-mitigating benefits of diversification in the private equity context. Indeed, for a given diversified portfolio of funds, the significant upside of fund investments performing well will generally compensate for the losses of funds which would not return the entirety of the commitments drawn.

Since a typical private equity investor (including bank investors) invests in dozens of private equity funds, with each fund in turn holding more than a dozen portfolio companies, a typical private equity portfolio easily consists of several hundred portfolio companies, which will have been acquired at different points in time, in various geographies, and at various valuations. Through the diversification at the level of portfolio companies, the individual private equity fund is able to generate a positive return for the investor even if an investment in an individual portfolio company yields a loss.

Furthermore, there is academic evidence that private equity fund investments are not normal distributed, but right-skewed. In other words, the statistical distribution of investment outcomes for private equity has "fat tails" on the positive side of the distribution. A private equity fund would need only one high-performing portfolio company in its portfolio in order to make a highly positive return for the fund investors. This is especially true in the context of venture capital, where the sale or IPO profits of one brilliant start-up will often compensate on its own for potential losses of several other investments.

The high degree of diversification – both at fund level and then at portfolio company level - is very important for assessing the risk of private equity investments generally, including from the perspective of bank investors, and has not always been properly acknowledged by regulators.

iv. Private equity funds are **relatively small in size**

Investments into private equity funds usually only represent a very small percentage of the institutional investors' total assets. The failure of a fund – or more accurately its inability to return capital drawn down from investors - would therefore only constitute a minor event for these investors, especially as they will usually commit capital to a various number of funds for diversification purposes. Furthermore, according to a BVCA study, in the case of a randomly selected portfolio with 20 funds, the risk for an investor to lose capital is no higher than 1.4%[4].

v. Private equity funds' investments have shown **resilience** during recent crises

Private equity funds' investments are made in unlisted businesses, which are less likely to be affected by market movements, and are diversified both geographically and among industries. The private equity fund structure can also be advantageous in times of a crisis when little alternative capital is available to finance companies' investments. A recent study on private equity and financial fragility

[4] BVCA, Risk in Private equity, October 2015

in the crisis found that private equity backed companies decreased investments relatively less than their counterparts during the crisis[5], making them a useful addition to the financial system at a time when much-needed investment may not be available from other sources.

Over the long term, private equity has consistently provided higher returns to investors than comparable public companies. For example, UK-based private equity funds (many of which invest on a pan-European basis) achieved annual net-of-fees returns of 11% over ten years to 2016, around double that of the FTSE All-Share index, according to BVCA figures, demonstrating their resilience during the crisis years[6].

[5] Harvard Business School, *Private equity and financial fragility during the crisis*, Working Paper, 18-005

[6] BVCA Performance Measurement Survey (PMS) - 2016

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Annex II: Relationship between banks and private equity funds

Credit institutions which are making investments in private equity funds typically have teams focusing solely on such investments, often within their Principal Investments department. Within these units, banks make a clear distinction between investments into private equity funds and other types of investments. As these divisions are operated by professionals with an extensive understanding of the private equity industry, teams managing a bank's private equity portfolio know which funds fall within this investment universe and which do not.

Banks (which represents 4% of the private equity's investor base) recognise what is an investment in a private equity fund as it will typically combine several clear business characteristics:

- any institutional investment in the asset class will be done through a limited partnership of 10-12 years' duration, usually comprising a number of institutional investors (limited partners) and the private equity fund manager (general partner);

- investors participate by making a legally binding commitment to invest a specified amount of capital in the fund - entitling them to a proportional share of fund interests;

  There is typically no obligation to increase their investment beyond this. They invest with the obligation to remain invested for the full life of the fund, and it is usually specified from the outset in funds' document they have no right of redemption before the end of the life of the fund.

- once it has received the capital from the credit institution (and the other investors it has fundraised from), the private equity fund manager draws from this capital pool to fund the acquisition of stakes (often controlling) in a number of portfolio companies over the course of the fund's investment period.

  The fund manager seeks to increase the value of the portfolio companies through long-term active ownership management exercised via the boards of these companies and exits these investments at a time deemed appropriate. The proceeds from divestments are distributed to the limited partners.

Institutional investors will gain exposure to investing in a portfolio of private equity funds, which is diversified, by vintage year, geography and stage of investment from early stage venture capital and growth equity, up to larger buyout funds. This largely mitigates the overall risk of the fund portfolio. There is therefore a substantial risk-mitigating benefits of diversification in the private equity fund context. Indeed, for a given diversified portfolio of funds, the significant upside of fund investments performing well will generally compensate for the losses of funds which would not return the entirety of the commitments drawn.

Since a typical private equity investor (including bank investors) invests in dozens of private equity funds, with each fund in turn holding more than a dozen portfolio companies, a typical private equity portfolio easily consists of several hundred portfolio companies, which will have been acquired at different points in time, in various geographies, and at various valuations. Through the diversification at the level of portfolio companies, the individual private equity fund is able

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The high degree of diversification – both at fund level and then at portfolio company level - is very important for assessing the risk of private equity investments generally, including from the perspective of bank investors. The overall risk-weight that should be applied to an investment in a private equity fund is therefore fundamentally different from the risk-weight that is applied to a single equity exposure, especially for investments in start-ups where a fund’s losses from some of its investments are compensated by the success of highly performing ones.

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.

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