INVEST EUROPE

Response to European Commission Consultation on macroprudential policies for Non-Bank Financial Intermediation

Question 1. Are there other sources of systemic risks or vulnerabilities stemming from NBFIs' activities and their interconnectedness, including activity through capital markets, that have not been identified in this paper?

No. We feel the paper gives an accurate and wide perspective on the risks posed by NBFIs. We support the approach taken by the European Commission, and before that by global institutions, to move away from an entity-based approach to an activity-based approach.

We also appreciate the European Commission paper recognises that not all NBFIs are subject to the same risks, with long-term closed-ended funds obviously not subject to the same liquidity risks than open-ended funds.

As recognised by the European Commission, NBFIs plays an important role in servicing the real economy, in particular by providing capital that public finance or banks are unable to give to businesses (for example, venture capital gives funding to start-ups that banks would have a hard time providing due to the perceived riskiness of start-up firms).

Overall, private finance is an important addition to banks and public markets, and its very presence helps diversify the real economy's exposure to public market volatility. As a segment of private finance, private equity is particularly relevant to both its investors and the employees of the firms it supports.

The main aim of private equity funds is to help build successful businesses by making long-term – on average six years - equity investments and by actively managing these investments. As such, private equity plays an important role in delivering economic growth that creates jobs and enhances the long-term competitiveness of the markets they are active in. Our data shows that private equity-backed firms have a higher employment growth rate than their counterparts (see our Private Equity at Work reports).

Private equity is equally important to institutional and sophisticated investors looking for opportunities. Pension funds and life insurers invest in private equity to get steady returns over the business cycle compared to other more volatile parts of their portfolio which are either invested in the public markets and exposed to volatility or are held in cash at bank and MMFs which are exposed to 'runs'. Our data shows private equity returns are higher than other asset classes, and therefore represent an important opportunity in a time of high inflation and low interest rates.

Private equity funds have not been confronted with the difficulty of managing large scale withdrawals by investors, leading to forced divestiture of assets and fuelling a decline in asset prices. This is because private equity funds do not generally provide any redemption mechanism for investors. Similarly, concerns that have arisen more broadly about short

selling and links to abusive trading strategies are not applicable to the private equity sector given their focus is on longer-term investment horizons and not trading strategies. Due to the very limited amount of transactions in the financial markets effected by private equity firms, their effect on the efficiency of the markets, price formation and trading conditions is, as a general rule, across the market as a whole, de minimis.

Question 2. What are the most significant risks for credit institutions stemming from their exposures to NBFIs that you are currently observing? Please provide concrete examples.

Overall, as financial institutions, private equity funds have limited direct financial exposures to other participants in the financial system, including to banks.

Private equity is an important investment opportunity to many investors, which may sometime include banks (although banks have largely retreated from the market due to the impact of Basel rules). Investments in private equity, from the institutional investors' viewpoint, are generally highly diversified, as funds invest in at least 10 companies and fund-of-funds offer exposures to at least 100 companies. Chances to lose some of the capital are low and when this happens, the amounts are limited. Of course, this risk is covered through prudential legislation that applies to institutional investors.

While these investments are illiquid – and must be managed by these investors as such, they mostly represent an indirect exposure to the real economy. Importantly, given the overall size of industry (especially in the European Union), private equity exposures typically only represent a small proportion of the overall exposures of these investors.

When banks invest in private equity, there will be strict mechanisms put in place that ensure they solely act as equity investors, in the same way as pension funds or insurers.

Banks may also lend to portfolio companies owned by private equity – but as this lending is legally made to an entity that is structurally separate from the fund, it is not different from lending to any other corporate entity. ECB Guidance on leveraged transactions limit the ability of banks to lend to companies owned by private equity. While these limitations are done in a relatively crude way (no interest is given to the actual risk posed by the lending to the company), these, along with the prudential requirements, address the credit risk of such loan for the bank.

In the section on leverage, we will address some specific types of lending credit institutions may make to the fund. It is however to be noted such lending is extremely rare and limited, as private equity funds are by trade not using debt to increase their returns at fund level.

Question 3. To what extent could the failure of an NBFI affect the provision of critical functions to the real economy or the financial system that cannot easily be replaced? Please explain in particular to which NBFI sector, part of the financial system and critical function you refer to, and if and how you believe such knock-on effect could be mitigated.

The private equity world has a whole is, contrary to the banking or insurance world, composed of a vast number of smaller market players rather than of a handful of large

institutions. This largely disseminates the risk of the failure of a single entity. Even larger entities will operate a large number of separate funds.

Moreover, a private equity fund is unlikely to fail in the same sense as a credit institution or an insurance firm would. The main risk for a manager is for its funds not to provide sufficient returns to its investors at the end of their run, as opposed to no longer having sufficient liquidity (all liquidity being provided through commitments by investors at the beginning of the fund's life) or being over-leveraged (as mentioned above, there is no typical use of leverage at fund level in a private equity context).

Beyond fundraising, private equity funds are not very intertwined with other market players as fund structures remain relatively simple, especially compared to credit institutions:

- Because they are typically unleveraged, private equity funds **do not engage in a significant amount of borrowing, nor do they use derivatives extensively at fund level (beyond prudent risk management hedging, for example of currency exposures) and thus** have limited counterparty exposure.

The maximum potential loss incurred by investors in the funds managed by our members is typically limited to the amount of their capital commitment i.e. even if the fund's investments perform poorly, the investor's loss is limited to their committed capital, and they cannot lose more than this amount. They are not liable for any debts or obligations of the fund beyond their committed capital. Moreover, they are not liable for any debts contracted by asset management company on its own behalf. Investors know their maximum risk exposure from the outset and are not liable beyond their agreed-upon commitment

- Private equity funds – even when two are managed by the same fund manager – are not exposed to each other as they neither pledge their assets as security nor guarantee each other's obligations.
- Private equity fund managers typically **do not undertake banking activities** and are not part of the credit intermediation chain

Private equity funds do not rely on short-term credit for their operations, nor do they lend to financial system participants. All these characteristics seriously mitigate any knock-on effects, which are further lowered by the small size of the industry compared to other market players.

Question 4. Where in the NBFI sectors could systemic liquidity risk most likely materialise and how? Which specific transmission channels of liquidity risk would be most relevant for NBFI? Please provide concrete examples.

Liquidity risk is essentially absent from the closed-ended fund space. This is especially true as a rule in the private equity world where investors do not expect to see returns on their investments before the end of the life of the fund.

Private equity shares with some parts of the real estate and infrastructure asset classes the concept that investment is made not in an asset, but in the project of development of an asset. The terms "active ownership" generally used in the market refer to a reality where the manager of a fund has for objective, when committing capital into a portfolio company,

to make long-term, structural improvements to the functioning in order to increase its value for selling several years later (5 on average).

Because of this, institutional investors committing the vast majority of the capital in private equity see the asset class as a thoroughly illiquid investment. Any "speculative" interest in selling shares for the sake of benefiting from changes in market condition is largely irrelevant in that context, as it is not expected that the company will have value until the moment it is ready to be sold.

This said, there will be situations, which we describe later in this response, where managers will create semi-open ended structures to allow some of their investors, in particular high net worth individuals and other "sophisticated" investors, to benefit from some liquidity. We cover the situation of these funds in our responses to the questions around liquidity of open-ended funds.

Question 5. Where in the NBFI sectors do you see build-up of excessive leverage, and why? Which NBFIs could be most vulnerable? Please provide concrete examples.

As representatives of private equity managers, it is not uncommon that we are regularly faced with misconceptions about the nature of leverage in our asset class, how it is typically calculated and what risk it is posing. As the Commission is seeking to better understand the use of leverage by non-bank players, we feel this question is an opportunity to address some of these misconceptions.

First, as an overarching point, there is no reason to think that, as noted by the Commission, "*excessive leverage could also go undetected when using complex investment strategies involving several legal entities and fund of funds*".

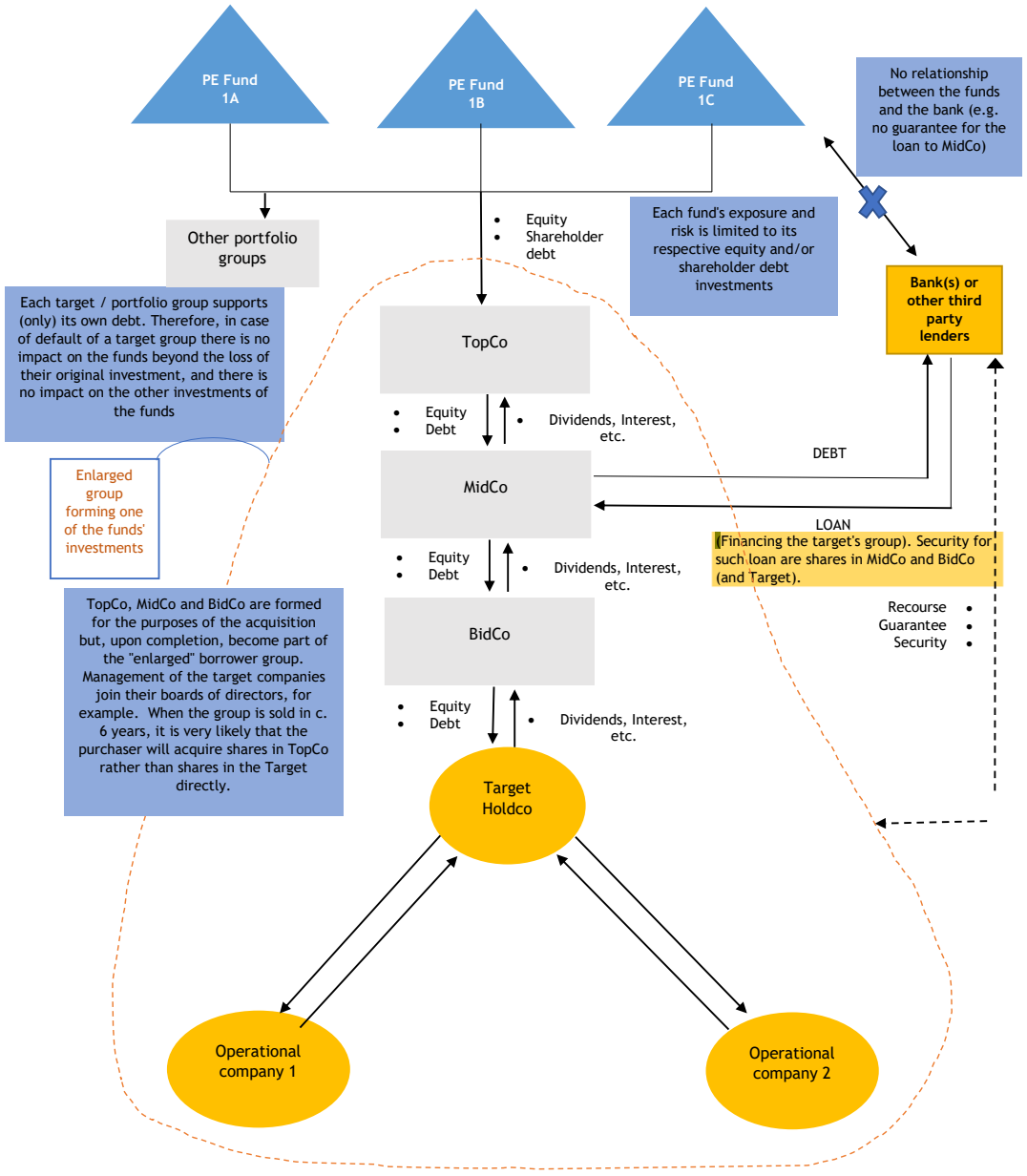
Under AIFMD, any leverage in financial or legal structures created by the AIF or the AIFM in order to increase exposures at the level of the AIF **must** be reported. Funds-of-funds also report on their exposures, as do the underlying funds in which they invest. If there is unreported leverage, this would only by a deliberate choice of manager to infringe the law – something that is of course rare by nature - and not by a fault of the current design (and arguably not something any law could prevent *a priori*). For example, the sentence "*detecting synthetic leverage via derivatives positions in some instances (such as through the use of other legal vehicles) can be very difficult*" is not true when it comes to AIFs, where derivative positions taken through legal structures are easily reportable.

From our own perspective as market participants, , it is crucial to stress, as mentioned in questions above, that private equity funds are primarily closed-ended funds, with limited liquidity concerns. Second, the term "leveraged buyout" which is often used to describe the industry is somewhat of a misnomer as it gives the overall impression that funds are leveraged – while the use of debt is made (except some circumscribed exceptions) at the level of the portfolio company.

In that context, many comments, including from international institutions working on the topic as well as the ECB, have been made that wrongly capture together debt of the fund

and the SPV as being connected while the debt of the Holdco AND of the Opco will be separated from the fund.

We find the below graph gives the most accurate representation of typical structures (although there will of course be differences from fund to fund, this model is by far the most representative one in the industry).



As can be seen from the graph, and importantly from a financial stability perspective, the **borrowing at the level of the portfolio company will have no bearing on the leverage of the fund** (if there is any). 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. This legal and economic separation is an essential feature of the private equity model and distinguishes it from corporate ownership that can be seen within trade groups.

Any counterparty (a bank, for example) that lends to a portfolio company (typically at the level of a holding company) is exposed to the operating companies in the structure. It is not exposed to, nor does it have recourse to, any fund that owns shares in the holding company. In the same way the bank would not have recourse to the listed company where it had used a holding company for an acquisition). If the holding company were to default (in either the private equity or listed corporate ownership scenario), the bank would exercise its security and potentially become the owner of the *operating group* (i.e., of the underlying assets in the holding company and the operating company). Most importantly, it would not be able to revert to the fund or the fund's investors.

In a private equity case, the maximum loss for the fund would be limited, as always, to the amount of equity it had invested in that specific holding company. Such failures have no bearing on other investments made by the fund because there is no borrowing across portfolio companies nor is there any recourse to the fund.

The description made above **does not preclude that there may well be circumstances where debt of the portfolio company could effectively affect the fund**. This could include situations where a fund is guaranteeing the debt of the portfolio company, where the debt is long-term, and/or the guarantee exceeds undrawn commitments. Importantly, such debt should (and we understand is) captured by the calculation of fund level leverage – and covered under existing AIFMD leverage limits rules.

Calculation of leverage at portfolio company level

There also appears to be overall confusion among regulators with the actual risk posed by leverage and the way this risk is assessed in a private equity context by lenders to the portfolio companies.

To assess the effective operational performance of private equity backed businesses, credit institutions, when considering the terms for lending to these businesses, will typically rely on other metrics than the debt/own capital one. One is the evolution over time of the ratio between the net debt of the company and its EBITDA. During the planned time of investment, EBITDA will be expected to rise at a certain pace while the level of debt will decrease. Another element to determine whether the company is in difficulty or not during the investment period is the ratio, calculated on a regular basis, between the company's free cashflow and the amount of debt that has to be serviced.

The structuration of these deals through quasi-equity and equity will not have any impact on the cash flow of the company that has received capital from the private equity fund.

Typical measures of leverage in a private equity leveraged buy-out context.

When a private equity fund invests in a company, the reimbursement of debt will be looked at by the lender through a series of measures whose main objective is to ensure that the debt of the company can be reimbursed over time:

1) **structural ratio**: this looks at the net debt over the assets of the company and/or its equity
2) **EBITDA ratio**: calculating the evolution of the net debt over EBITDA over time

3) **interest cover ratio**: looking at whether the cash EBITDA covers interest costs to be paid on a yearly basis

The third ratio is the most important from a private equity perspective – the least important of the ratios will be the structural one, which should always be met if the other two are met.

These 3 ratios are negotiated at the moment of the investment and capture the risk posed by the use of debt in a leveraged buyout context. The more stable the company is, the larger the debt service can be. If one of these ratios is not met, the bank may change the terms of their debt service.

Use of the leverage definition

We note that the consultation sometimes deals with the term "leverage" in an imprecise way. It is defined in footnote 16 as "*any method by which a legal or a natural person increases its exposure to an asset whether through borrowing of cash (financial leverage) or through borrowing securities or through leverage embedded in derivative positions (synthetic leverage)".* This is similar to, but in fact quite fundamentally different, from the carefully crafted definition of "leverage" for the purposes of AIFMD.

Amongst the differences is that this is confined to exposures to assets (i.e. long positions) as opposed to also catching short positions (such as guarantees or other liabilities). This gives rise to confusion because, in some places in the consultation, the Commission refers with approval to e.g. leverage limits under AIFMD, which are by reference to the AIFMD definition.

Finally, we alert the European Commission that the leverage definition in AIFMD has implications far beyond AIFMD – including for the financing of the EU economy. For example, the level of Solvency II risk weights for insurers' investments in equity are determined by the use or not of leverage by fund managers. An uncalibrated change to the definition could mean that many venture and growth funds could no longer be able to be deemed unleveraged – which would be counter to the general Savings and Investments Union objectives.

Question 7. Considering the role NBFIs have in providing greater access to finance for companies and in the context of the capital markets union project, how can macroprudential policies support NBFIs' ability to provide such funding opportunities to companies, in particular through capital markets? Please provide concrete examples.

Macroprudential policies of course have a key role to play in providing stability in the market, by avoiding extreme scenarios. Reversely, it is important that these policies are drafted in a way that takes into consideration the nature of the asset class.

For example, would this Commission's exercise lead to a redefinition of the concept of leverage in the EU, and put in question the actual delineation between leverage at fund level and leverage of portfolio companies, this could suddenly create a situation where many small market players in the venture and growth space could find themselves subject to the

complex requirements of the AIFM Directive, endangering their ability to channel capital from institutional investors to innovative businesses.

This is because the thresholds for being subject to the AIFMD are directly related to the amount of leverage at fund level. As these funds are typically not leveraged but their portfolio companies are, a new delineation could mean funds currently outside the AIFMD scope could be subject to rules for the sole reason companies they invest in are using debt.

Similarly, rules on liquidity, whose main purpose is to avoid market panic, should be carefully drafted not to have unintended effects.

Question 16. How can NCAs better monitor the liquidity profile of OEFs, including redemption frequency and LMTs, in order to detect unmitigated liquidity mismatches during the lifetime of OEFs?

Private equity funds, which are traditionally set up as closed-ended funds, are generally synonymous with illiquidity. Because of the long-term nature of the asset class investments, which requires invested businesses time to mature, investors cannot easily sell their shares or interests in the fund whenever they want. Unlike publicly traded stocks, which can be bought and sold on the open market, private equity investments are locked up for a specified period, on average five to six years.

Most private equity funds are therefore entirely out of any liquidity concern, as there is no possibility of runs. This is recognised in EU law that only applies liquidity rules to open-ended funds.

There are however some private equity funds which will be open-ended and offer some redemption opportunities to their clients: this is the case of semi-liquid funds.

Semi-liquid private equity funds are a relatively new type of investment vehicle that bridges the gap between traditional, illiquid private equity funds and more liquid public market investments. Their purpose is to offer investors the potential for higher returns associated with private equity (and other alternative assets) while providing a degree of liquidity not typically available in traditional private equity funds.

Semi-liquid funds often have a (semi) open-ended structure, which allows investors to invest and withdraw their capital at specific intervals (e.g. monthly or quarterly), subject to pre-agreed caps on how much capital investors can withdraw at any given time. Such caps help the fund manager to match the fund's portfolio of liquid assets (which can be liquidated to fund redemptions) to the maximum amount of redemptions that are permitted in a given period. Other features of these funds include long notice and settlement periods for redemption requests and a generally more diverse investment strategy than regular private equity funds.

With their hybrid approach, semi-liquid structures offer access to alternative assets to a new range of clients with a different liquidity profile, with positive impact on the overall diversification of portfolios. From a European regulatory perspective, the repurposing of the ELTIF Regulation has equally made it more interesting for a small proportion of private equity managers to develop more liquid products.

Semi-liquid funds must be subject to liquidity rules, and develop liquidity management tools, but regulators should take into consideration that they are fundamentally different than fully liquid structures. Indeed, contrary to UCITS, their underlying investments are not volatile by nature. As explained in Question 1, private equity funds are investing in companies with a long-term perspective, which mean that investments only mature after several years (the time for the investment to be made and for the invested companies to have grown/evolved under the minority or majority ownership of the manager). In that context, investors do not have the same economic interest in selling their shares in case of a market recession, meaning that runs are much less likely in a private equity context. Liquidity in these circumstances is mostly offered to leave the investor with sufficient flexibility to sell their assets in case of changes to their own situation and is much less exercised than for investments.

We are happy to help the European Commission determine how this can be integrated into common rules for all AIFs, for example by leaving some flexibility in terms of choice of liquidity management tools.

Question 17. What is the data that you find most relevant when monitoring liquidity risks of OEFs?

AIFMD already requires managers to report information on liquidity. This data should be the one used at EU level.

Question 19. On the basis of the reporting and stress testing information being collected by competent authorities throughout the life of a fund, how can supervisory powers of competent authorities be enhanced to deal with potential inconsistencies or insufficient calibration between the LMTs selected by the manager for a fund or a cohort of funds and their assets and liabilities liquidity profile? How can NCAs ensure that fund managers make adjustments to LMTs if they are unwilling to act? How could coordination be enhanced at the EU level?

If we fully agree with the Commission that the activation of an LMT should remain full responsibility of the manager, we strongly disagree with the Commission's proposal to empower NCAs or ESMA to require the AIFM to select a specific LMT for a fund or cohort of funds. For reasons detailed below, there is extreme relevance, including from financial stability perspective, of having rules that are adapted to the realities of different fund types, as per our comments in Question 18. Further limiting the use of LMTs could have disastrous consequences, as rules that would not sufficiently be tailored could create risks of paralysis or runs where there are currently none.

In particular, we would suggest that regulators should always be mindful to:

(i) **leave flexibility for AIFs to select their two LMTs based on the specific features of those funds**

The number of LMTs available to semi-liquid products is very limited as a number of the LMTs identified in Annex V of AIFMD Level 1 are not suitable for an effective liquidity management strategy for a semi-liquid fund.

(ii) recognise that redemption programmes used by semi-liquid funds are falling under the redemption gate definition - and that "soft locks" should fit within redemption fees or anti-dilution levies

Semi-liquid products already employ highly effective liquidity management techniques including but not limited to what is known as a "redemption programme". A redemption programme is a mechanism to cap redemptions in a given period (e.g. 5% of NAV per quarter, the "Cap"). If shareholders submit redemption requests and the value of those requests exceeds the Cap, the manager can, but is not required to, limit redemptions to, in this example, 5% of NAV in that quarter. The manager will typically redeem pro rata to each redeeming shareholders' shares/units, so that each investor has part of their redemption request satisfied. The Cap is typically sized in an amount that is similar to the value of liquid investments held by the fund.

Moreover, "soft locks" (fixed temporary early redemption fees) used by managers could be eligible as a redemption fee or an ADL.

(iii) **A general call to ensure that standards are appropriately crafted to account for the diversity of investment strategies and underlying assets of AIFs**

With rules too centred on the realities of UCITS funds, the risk is enormous that this will hinder the development of products offered to certain types of investors which have the potential to unlock capital for European businesses.

As noted above, financial stability is paramount, but appropriate flexibility to tailor LMTs to an AIF's investment strategy and assets, coupled with appropriate market transparency through disclosure and partnership with applicable Member State authorities, will help support investor protection while ensuring that rules do not assume that all funds are faced with the same risk and all investors behave in the same way.

Coordination is of course needed at EU level, especially as some national competent authorities have greater experience of some markets than others. The European Commission and ESMA should continue to play a key role in maintaining such coordination.

Question 21. [To asset managers] What difficulties have you encountered in measuring and monitoring liquidity risks and their evolution? Are there enough tools available under the EU regulations to address liquidity mismatches?

For the few private equity managers setting in place semi-liquid funds, managing and monitoring liquidity risks of the fund is a key – if not the key – responsibility of the manager. Given the overall illiquidity of the assets, assets themselves are not likely to become significantly more illiquid than they already are when the fund is set up (for example a start up in which a venture fund is in any case unlikely to become viable for an exit sale before several years). Meanwhile, liquidity of clients is typical that of high net worth individuals and family offices whose level of understanding of the illiquidity of the underlying asset

limit the risk of runs. For these reasons, it would be a mistake to look at the evolution of liquidity on a too macro basis.

In our opinion, there are enough tools available under the EU regulations to address the liquidity risk of open-ended AIFs. The recently revised AIFMD offers a wide and harmonised range of liquidity management tools, from which AIFMs have to choose two. In addition, it allows these managers to put in place any other additional tool they may deem relevant (e.g. soft closures).

Question 26. What are your views on the preparedness of NBFIs operating in the EU in meeting margin calls, and on the ways to improve preparedness, taking into account existing or recently agreed EU measures aimed at addressing this issue? Please specify the NBFI sector(s) you refer to in your answer?

Private equity funds **never trade** in derivatives and thus are not concerned by risks identified in this section.

Question 27. What are relevant risk metrics or tools that can be used to effectively monitor liquidity and margin preparedness across all NBFI entity types? Please provide examples specifying the sector you refer to.

Private equity funds **never trade** in derivatives and thus are not concerned by risks identified in this section.

Question 43. What are other tools than those currently available under EU legislation which could be used to contain systemic risks generated by potential pockets of excessive leverage in OEFs?

As a reminder, private equity funds are typically unleveraged and closed-ended, so will not give rise to the concerns identified in this section. Nonetheless, we would like to comment that from our perspective recently revised AIFMD rules cover the risks of excessive leverage.

Question 44. What are, in your view, the benefits and costs of using yield buffers for Liability-Driven funds, such as it was done in Ireland and Luxembourg, to address leverage?

NA

Question 45. While on average EU OEFs are not highly leveraged, are there, to your knowledge, pockets of excessive leverage in the OEF sector that are not sufficiently addressed? Please elaborate with concrete examples.

As explained in Question 43, open-ended private equity funds are by nature unleveraged.

It is important, for reasons described in answer to Question 5, to distinguish leverage of the fund, which increases the exposure of the fund and is posing a risk to the fund, and the use of debt by the portfolio company in which the fund has invested, which is ring-fenced to that specific company.

There may be situations where private equity funds are leveraged, either when they borrow money that is not backed by uncalled commitments or when the fund is guaranteeing the debt of a portfolio company (a practice that is currently rare in EU markets). These situations are covered under existing AIFMD leverage calculation and is therefore in the knowledge of EU regulators.

Question 46. How can leverage through certain investment strategies (e.g. when funds invest in other funds based in third countries) be better detected?

This question mostly concerns EU fund-of-funds (FoFs) that would make investments into non-EU funds that would use leverage.

Would there be leverage in any of the underlying fund, the fund-of-fund manager would have, as part of its due diligence process, diversify the exposure. If that would not be the case the leverage of the underlying investee AIF would in any case need to be reported by the fund-of-fund as is own exposure.

Given the absolute low levels of leverage in play in the private equity fund space, it would seem vastly disproportionate to require FoF managers to report on leverage in a diverse range of underlying AIFs.

Question 47. Are you aware of any NBFI sector entities with particularly high leverage in the EU that could raise systemic risk concerns?

No.

As mentioned before, the private equity industry is generally composed of unleveraged funds. When funds are using debt, it is under specific circumstances and it generally correspond to small amounts of debt. In other words, the short-term answer to this question from a private equity perspective is no.

We are aware that there are debates around the use of subscription credit lines (SCLs), Net Asset Value (NAV) Facilities and Collateralised Fund Obligations (CFOs). These instruments will typically be calculated as leverage under AIFMD, in some cases even when they are not increasing the exposure of the fund.

Most importantly, **these tools, which are counter-cyclical in nature (as they allow the fund not to sell long-term assets at down times), neither represent a significant share of the market nor do they constitute "substantial" leverage**.

For the convenience of the European Commission, we detail these in an Annex to our position paper and are more than willing to talk about them through follow-up conversations.

We would like to use the opportunity of this question to flag that it is crucial to maintain string channels of communication between regulators and industry participants to distinguish which of these instruments are leverage (when they increase the fund's exposure) and which are not. This exercise is particularly relevant for leverage data collected under AIFMD to remain meaningful.

Question 48. Do stakeholders have views on macroprudential tools to deal with leverage of NBFIs that are not currently included in EU legislation?

The fund managers we represent are covered by EU legislation so we do not have views on this question.

On a broader basis, what should be particularly avoided is the imposition of rules drafted for banking players to market players who do not share the same characteristics as banks.

Question 52. Do you have concrete examples of links between banks and NBFIs, or between different NBFI sectors that could pose a risk to the financial system?

Private equity funds have generally limited direct financial exposures to other participants in the financial system. When they do, the impact of existing exposures is often misunderstood by regulators.

Private equity as an equity opportunity for institutional investors (incl. banks)

Private equity is an important equity investment opportunity for many investors, whether pension funds, insurers or, in very limited cases, capital markets. Investments in private equity, from the institutional investors' viewpoint, are generally highly diversified, as funds invest in at least 10 companies and fund-of-funds offer exposures to at least 100 companies. Chances to lose some of the capital are low and when this happens, the amounts are limited. While these investments are illiquid – and must be managed by these investors as such-, they represent an indirect exposure to the real economy. Importantly, given the overall size of industry (especially in the European Union), private equity exposures typically only represent a small proportion of the overall exposures of these investors.

Banks represent less than 5% of the sources of capital in private equity. Since Basel II and III agreements, **banks have regrettably but essentially exited the business of (i) investing equity in private market funds and (ii) managing private market funds**.

Of course, this risk is and should be covered through prudential legislation that applies to the banks – but arguably the current balance is over-prudent rather than too relaxed. We have long argued that the current level of capital charge attached to equity investments- which at 150 to 400% is effectively punitive - is ultimately damaging to the stability of our continent. Because current risk weights have led to the near total absence of banks as equity investors, they have severely hampered the capacity of equity investors to commit a limited portion of the capital of banks to innovative businesses through diversified fund structures. Given the banks' relevance in the EU financing system, as opposed to the US capital market based economy, this is a key part of the EU competitiveness problem. Moreover, from a risk point of view, the capital charge for equity has historically been discriminatory against fund exposures – as it never took into account risk diversification benefits of indirect exposures into funds (as opposed to riskier direct investments).

Banks as lenders to "private equity"

Private equity funds themselves are not lenders and are generally unleveraged (and never substantially leveraged). They also do not trade in derivatives. The main relationship of private equity with the banking sector is through the debt it receives from it in specific circumstances.

First, banks may provide debt to private equity deals to finance the buying of a portfolio company (the "buyout" model). Importantly, and as flagged above in the leverage section of this paper, such debt is economically provided to a corporate – the portfolio company in which the fund has invested - and not to the private equity fund itself. Moreover, any portfolio company group into which a fund has invested is managed independently. In the case of a buy-out fund, each deal has its own specific holding company, protecting both other portfolio companies and other funds from the implications of those investments being unsuccessful. Even if a private equity fund is unsuccessful in its investment strategy, it does not pose contagion risk or have systemic risk implications in the same way as entities which are strongly inter-connected might.

Banks may also provide debt to fund specific tools designed to provide some level liquidity in the market to "bridge" the time between the equity capital calls to the fund's investors and the actual investments: when such a debt is provided, this is under strict conditions and the oversight of the fund's institutional investors. We describe these deals in an Annex to this response.

Overall, the link between banks as lenders and private equity structures as recipients of such lending has recently been the object of much confusion – as ring-fencing mechanisms put in place within the fund for these exposures not to impact each other have not always been taken into consideration.

Overall, any systemic risks to the banking sector should be – and arguably already is - addressed **by tweaking legislation applicable to credit institutions**. Rules are for example already in place to limit the ability of banks to act as lenders to private equity-backed companies. While we have long questioned the shape of these rules (which apply indiscriminately to any private equity-backed company irrespective of its business fundamentals), they are by and large already addressing any of the risks that the use of such debt poses.

Private equity and private credit

While private equity funds may be part of structures that also host private credit funds, there is no overlap between private equity and private credit activities.

Firms have different models for mitigating such conflicts. As a general proposition, the private equity and private credit businesses are **distinct business lines and have distinct investment committees**, staffed by different teams of investment professionals with differing expertise, and usually housed within separate legal entities.

Some firms will not, as a matter of policy, **permit their private credit funds to lend to companies in which their private equity funds are invested**, and the firm will operate

formal allocation policies to determine which business line should pursue any given opportunity.

Other firms put in place **strict information barriers between investment teams and/or decision makers**, to ensure that information is not shared inappropriately and that decisions can be taken independently having regard solely to the interests of the investors in the relevant fund. If a conflict crystallises, this will typically be referred to the limited partner advisory committees of the relevant funds to approve the proposed course of action.

No matter what happens, it is important to flag that **each fund is raised by a specific team**. This team has a fiduciary duty towards the investors of each team (credit or private equity). The track record belongs to this specific team. The team has an incentive to preserve its track record, to be able to raise future funds. Belonging to a wider structure and sharing a brand does not mean that these requirements substantially change. There are information barriers, processes and rules to manage conflicts of interest that fund investors check when investing in funds. These cases are actively addressed by these rules and processes.

Question 53. What are the benefits and costs of a regular EU system-wide stress test across NBFI and banking sectors? Are current reporting and data sharing arrangements sufficient to perform this task? Would it be possible to combine available NBFI data with banking data? If so, how?

The costs of creating such a system would be immense and, given the differences in the way both market players operate, it would bring very little benefit – and risk comparing as the same practices that are dissimilar in practices.

Question 58. How could the currently available coordination mechanisms for the implementation of macroprudential measures for OEFs by NCAs or ESAs (such as leverage restrictions or powers to suspend redemption on financial stability grounds) be improved?

In our view, the mechanisms in place are sufficient.

Question 61. Are there other ways of seeking coordination on macroprudential measures and possibly of reciprocation? What could this system look like? Please provide concrete examples/scenarios and explain if it could apply to all NBFI sectors or only for a specific one.

We would like to use the opportunity of this question to flag again that there could be downsides in developing measures that are covering all types of market players as if they were behaving in the same way.

As flagged in our different answers to this consultation, there needs some flexibility when it comes to liquidity rules to acknowledge the different features of closed-ended funds and a recognition of the distinction between fund and portfolio company leverage. For these reasons any high level macroprudential measures are unlikely to be effective.

ANNEX: Private equity and its tools to manage liquidity

In this Annex we would like to describe some situations where private equity funds may be deemed leverage. As flagged in our answer to Question 47, none of these tools lead to high levels of leverage – but given the interest of the European Commission on the topic of leverage, we felt a description could be found useful.

Subscription credit lines (SCLs)

The use of subscription credit lines (SCLs) by private equity funds can have an impact on the performance of the fund as it shortens the effective investment period, particularly when measuring performance with metrics like the Internal Rate of Return (IRR).

However, this is not the reason why SCL are widely used and the impact on IRR is nuanced as it depends on several factors. It is also important to underline here that the performance of a fund cannot be reduced to a single metric, such as IRR.

Subscription line facilities are backed by uncalled commitments made by the fund and are therefore not as such leverage, because they do not increase the exposure of the fund.

Use of SCLs

- Subscription credit lines are intended to **ensure that the fund has immediate access to capital or liquidity without the need to make a commitment call**.

This flexibility allows fund to move quickly when investment opportunities arise without the need to wait for the capital contributions or avoid making pre-emptive capital calls with a risk that the investment is ultimately not made. Shortly following an investment financed with a SCL, the capital commitments are drawn and used to pay off the outstanding under the SCL. Therefore, given the short period of a capital call delay, the impact on the IRR would be negligible.

- Likewise, SCLs are also used to **cover the day-to-day operating costs of the fund** (or sometimes smaller add-on investment) without the need to make intermittent small-size commitment calls

Their purpose is to create less administrative work for the investors and the fund. In such a case, the capital commitments may be delayed for a longer period but the effect on the IRR will be marginal as the nominal amount of delayed capital contributions is in any case relatively small.

Conclusion

SCLs serve to enhance the efficiency of fund operations and are generally regarded as a convenient tool that benefits both managers and investors. As such, their usage is widely adopted by market participants.

In essence, the SCL can be seen as a tool to mitigate certain inconveniences intrinsic to the operational nature capital calls, but not one to replace or add to capital contributions. This is also why SCLs are *short-term* facilities that are *backed by the capital commitments* of the fund. Thus, SCLs are intended as a source of liquidity and portfolio management tool

that simplifies the operations of both the fund manager and its investors, rather than a source of leverage or instrument to boost IRR.

Overall, SCLs pose very little risk as they effectively bridge to the eventual contractual contribution of capital by a diversified group of investors, all of which are strong counterparties.

It is worth using this occasion to remind that, despite all recent crises, it is extremely rare, if not unheard of, for an investor to default on a fund capital call, given the consequences would be forfeiting their entire claim in that fund.

NAV Facilities

NAV Facilities and CFOs are two financial instruments used in the private equity sector to manage liquidity of the fund. However, these instruments do not inherently lead to new risks. Private equity firms often employ risk management practices to mitigate potential risks. These methods are designed to ensure that funds can use leverage, when they use leverage, effectively and responsibly.

These typically refer to a term loan (or, to a lesser extent, a revolving credit facility) secured by the fund's underlying portfolio of investments, and, as such, the size of the facility is linked to the net value of the portfolio (i.e., the value after deducting debt on the level of the portfolio companies).

Current use of NAV facilities

They remain a niche product in Europe and most managers are not using them. Market practice at the moment, especially in Europe, is for managers only to establish these after explicit consent or consultation with their investors. Where investors indicate approval, it will be on the basis the financial risk profile of the facilities is low. Investors ask their managers to report performance with granularity which generally allows them to split out any benefit from NAV financing, so there is transparency when it comes to the impact on returns.

- NAV facilities should generally be seen as **alternative way of (re-)financing** where traditional bank facilities are hard to obtain or costly, rather than a layer of leverage.

NAV Facilities indeed provide flexible and efficient access to liquidity to finance capital expenditures and/or add-on investments for portfolio companies.

- They are commonly used by (**near) end-of-life funds that have deployed (almost) all capital commitments to make investments and can no longer rely** (or at least only to a limited extent) **on capital commitments** to meet their liquidity needs or borrow under a subscription-backed credit facility (due to the lack of uncalled commitment).

In such circumstances, the NAV facility offers a compelling source of liquidity as the fund may use its investment portfolio to obtain commercially better credit terms in exchange for granting security.

- Funds may also use NAV facilities to **refinance close-to-maturity credit facilities of their portfolio companies.**

This reduces borrowing costs as high yield leveraged loans are more expensive to service.

- NAV facilities are also used to **support and extend the holding period of portfolio companies during an economic downturn** to wait for the market to rebound to exit at a higher valuation.

This allows them to operate counter-cyclical and thereby increasing financial stability.

How they are used

The borrowing base of the NAV facility is calculated on the basis of the net value of eligible portfolio investments satisfying certain inclusion/exclusion criteria and often subject to concentration/sector limitations, typically resulting in a conservative Loan-to-Value (LTV) ratio.

Consequently, the potential additional leverage is limited, particularly when portfolio-level leverage is already high. Furthermore, the high LTV of NAV Facilities, combined with the diversified nature of the underlying portfolio, offers robust security, shielding lenders from idiosyncratic asset risks. As such, the collateral securing the NAV Facility constitutes a strong buffer against a contagion of credit risk in the event of default.

Alignment of interest between fund managers and investors & impact on financial stability

The fund manager and investors - limited partners (LPs) - are both subordinated to NAV lenders, who have top priority for distributions. For private equity managers, defaulting on a NAV facility would have severe consequences (i.e.: the (complete) loss of investment) and impact their ability to secure future capital commitments. Therefore, the NAV facility is highly unlikely to be a source of conflict of interest.

In essence, NAV Facilities do not increase risk but rather enhance financial stability. They provide private equity funds with an alternative liquidity source to support and maintain their portfolio (especially in times where credit is scarce) while lenders benefit from strong security rights linked to high LTV ratios. This enables private equity funds to generate liquidity without the necessity of exiting investments during unfavourable market conditions, allowing them to operate counter-cyclical. Therefore, we disagree with the statement that NAV facilities would constitute a new 'source of risk' but argue instead that they may provide a source of financial stability. Moreover, these remain transparent in the sense they are disclosed to investors and ultimately approved by them – and where they lead to fund leverage, this is captured by leverage metrics as defined in EU law.

Finally, NAVs are conservatively structured with low opening LTVs and wide covenant levels to allow for a substantial drop in NAV before triggering distress – typically 50% or more. This drop in NAV is well in excess of that seen by the vast majority of European private equity managers during the financial crisis.

Collateralised Fund Obligations (CFOs)

CFOs are a form of securitisation involving the acquisition of a pool of private equity fund interests by a special purpose vehicle (SPV). The SPV's financing of the acquisition is achieved through the issuance of (tranches of) debt and equity notes to investors.

CFOs are a development driven by investors in private equity, given the need for these to have a diversified pool of private equity interests, rather than being driven by individual managers themselves. It therefore is inaccurate to refer to CFOs as a level of leverage within private equity.

Overall, CFOs **remain a niche area**, and whilst the liquidity they represent is welcome, they are not expected to constitute a meaningful portion of underlying investor demand.

Structure

Chiefly, a CFO is a fund-of-fund but structured as a securitisation vehicle with different tranches of debt and equity. The anticipated cash flows from the underlying private equity funds are used to make payment under the notes. To ensure a consistent dividend stream for CFO noteholders, the underlying fund interests are often of different vintages, with payments flowing first from older vintages and then from younger ones. The debt tranches have priority in terms of cash flows, whereas the equity tranche is the most junior and absorbs first losses (in return for potentially higher returns).

Therefore, CFOs are well structured instruments that reduce risk through diversification of both their inbound as outbound cash flow combined with a pre-emptive allocation of risk, which enables more robust risk management by its investors.

Other relevant elements

CFOs will be **rated**, and the rating agencies will investigate the underlying structures in some detail.

CFOs offer **dual-layer diversification**: they hold interests in various funds, and these funds, in turn, invest in a range of portfolio companies. In addition, CFOs are in principle over-collateralised as a result of eligibility and concentration limits. The CFO generally receives a higher credit rating than the underlying individual investments.

In any case, the credit risk is spread among the different noteholders among different tranches, which allows for a more granular allocation of risk depending on the investors' risk appetite and loss-absorption capacity. In other words, the underlying fund interests indirectly provide robust credit support to noteholders, while the tranche division offers structural credit enhancement to senior noteholders.

Senior notes are often rated investment grade, making CFOs an attractive choice for institutional investors like pension funds and banks subject to risk-weighted capital requirements, as they may prefer investing in CFOs over direct investments in the underlying funds. Therefore, the senior tranches of CFOs are considered investment-grade instruments that allow regulated financial institutions to provide the requisite liquidity to the market thereby increasing market stability.

Role

CFOs allow funds to unlock capital from some or all of the fund’s assets to return to investors in situations where a full exit may not be possible or desirable due to commercial, macroeconomic or geopolitical reasons.

They provide liquidity and can enhance returns for the equity tranche of the CFO. Indeed, through the utilisation of a CFO, fund investors can strategically adjust their portfolios. This includes unlocking capital for further investments with preferred managers and rebalancing their portfolios to align with preferred investment styles, industries, or vintages. A fund manager can pool diverse fund interests and secure capital by using them as collateral.

Additionally, investors find CFOs appealing because this structure offers access to a diversified pool of investments featuring an improved credit rating. Furthermore, it serves

as a tool for investors to navigate market volatility within their existing portfolios of private equity investments. Therefore, both on the fund manager as investor side, CFOs are a boon to portfolio risk management.

Conclusion

In conclusion, **CFOs do not add a layer of leverage**, but instead transform private equity interests in a more resilient instrument that unlocks liquidity in the market for their managers.

As such, it adds flexibility to the private equity landscape by making fund interests more liquid, which enables investors to better navigate market volatility and reposition their investment portfolio in line with their risk polices while mitigating risk through diversification.