Andreas Dombret: Private equity and Basel III

Keynote speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the 12th BVK German Private Equity Day, Berlin, 12 May 2011.

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1. Introduction

Ladies and gentlemen

Thank you very much for your invitation to the 12th German Private Equity Day. I am, as ever, impressed by the atmosphere in the wonderfully designed glass courtyard of the Jewish Museum. It is certainly a step ahead of the international financial system in terms of the abundance of light and transparency. In this, the largest global financial and economic crisis in decades, we are becoming painfully aware of just how many dark corners and opaque areas of the financial sector there are.

In order to prevent similar developments in the future, several important reform steps have been agreed, for instance the new capital and liquidity requirements generally known as Basel III. Other important measures, for instance to monitor what is generally described as the "shadow banking system", have been initiated. Of all the new rules, the European Directive on Alternative Investment Fund Managers is doubtless of most interest to private equity companies. It is to establish the regulatory framework for alternative investments in the European Union from mid-2013 onwards. I am convinced that it will not only impose new duties on private equity companies. Indeed, greater transparency and improved sales possibilities represent a large opportunity, particularly for private equity firms.

I would like to start my presentation by briefly discussing private equity's macroeconomic importance. I will subsequently outline what has been achieved so far in terms of financial sector reform, focusing mainly on those regulatory initiatives that are of particular relevance to the private equity industry. And lastly, I will attempt to shed some light on the issue of the "shadow banking system".

2. On the significance of private equity

On the long road towards a post-crisis world in which there is a greater distinction between equity and debt and the two are – as is appropriate – perceived differently, I am sure there is no need to reiterate the economic benefits of private equity. Private equity's positive role as a form of equity is obvious. As you know, private equity can be provided in all phases of an enterprise's life cycle, from venture capital to financing growth right up to buy-outs. In Germany, the many small and medium-sized enterprises that form the backbone of the German economy are the main beneficiaries of the equity capital that your industry provides. Countries with a greater share of private equity investment also, on average, have higher growth rates.[1] Private equity is also an important variable for the German labour market: BVK statistics show that, at the end of 2010, German portfolio enterprises in which private equity companies were invested employed some 1.2 million people.[2]

As for the financial sector as a whole, the last few years were not exactly rosy for private equity companies either. Investments by private equity companies, which had plummeted during the crisis, are now, however, showing signs of recovery. In 2010, new investments by

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[1] See Meyer (2006): Private Equity: Spice for European Economies, Journal of Financial Transformation, Vol 18, November, pp 61–69.

[2] See BVK statistics – The year 2010 in figures, March 2011.

private equity firms in Germany rose by almost 60% year-on-year to stand at €4.4 billion. Capital invested by German private equity companies thus totalled just under €36 billion last year. At roughly 0.1% of German GDP in 2009, investments are, however, still relatively insignificant. Moreover, they are below the European average of just under 0.2% of GDP.[3] However, that also demonstrates the growth potential of the German market for private capital. Generally speaking, growth always requires a stable environment, and that brings me to the reform of the international financial system.

3. Reform of the international financial system: the road towards new regulation

It is clear that we must do all we possibly can to prevent a repeat of the global financial and economic crisis that has been keeping us enthralled for some four years now. Reform of the institutional and regulatory framework of the international financial system is therefore in full swing; and it has doubtless already been improved significantly in key areas.

Besides creating greater transparency, a central aspect of the ongoing reform is to increase the quality and quantity of financial institutions' equity capital. The new capital and liquidity standards for the banking sector were discussed at length; they will go into the post-crisis text books as "Basel III". The new rules will ensure that capital requirements rise considerably – in terms of both quantity and quality. To ensure that financial institutions have a better liquidity cushion in future and are less vulnerable even in periods of stress, the first-time introduction of global liquidity standards has been agreed.

The G20, at their meeting in Seoul in November of last year, committed themselves to implementing the new standards. This voluntary agreement must now be fulfilled, and an internationally consistent implementation of the agreements must be assured.

Another subject that is closely associated with Basel III is already being tackled: the right way to deal with systemically important financial institutions. Such institutions, called SIFIs for short, are defined as particularly large, particularly complex and/or particularly interconnected institutions or as those that exercise specific functions that other market players cannot easily take on. The insolvency of SIFIs is therefore regarded as virtually intolerable.

Back at the Seoul Summit, the G20 accepted a comprehensive concept on how to deal with SIFIs put forward by the Financial Stability Board. Work on specifying the individual recommendations is currently being pursued as a matter of urgency, and the final framework is to be ready at the latest by the next G20 Summit in Cannes in November. Here, too, the focus lies on increasing the quantity of capital held, as a central component of the FSB concept are systemic capital surcharges for SIFIs that go well beyond the requirements of Basel III. These surcharges can take the form of a higher tier 1 capital ratio or contingent capital, ie debt that converts into equity if the institution becomes distressed, for example contingent convertibles.

These are all important steps towards enhancing individual institutions' resilience through more and better-quality capital. They simultaneously strengthen the resilience of the financial system as a whole. At the same time, the regulations must not overshoot their objective and cause disproportionately high macroeconomic costs. However, I do not think that will happen. For instance, a joint Basel Committee and FSB working group analysed the macroeconomic impact of the proposed stricter regulatory standards during the transition

[3] See EVCA/PEREP Analytics, http://www.evca.eu/uploadedFiles/Home/Knowledge_Center/EVCA_Research/Statistics/4_3_Investment/YB10_Private_equity_investment_as_a_percentage_of_GDP.pdf.

period. It concluded that while the transition to stricter capital and liquidity standards will cause slightly higher capital costs, the impact on economic growth should be small overall.[4]

Nonetheless, there is no denying that implementing Basel III will cause more intense competition for funds. For leverage in the banking system overall to drop, more capital will be required. At the same time, the crisis has raised all market participants' risk awareness. Although the possibility of another exaggerated "search for yield" cannot be generally ruled out in future, risk managers can initially be expected to take a more critical stance. My next point is directly related to that: I am firmly convinced that investors will tend to spread their risk even more than they do at present; investments will therefore be more diversified and also smaller overall. Finally, I believe that "covenant lite" structures have seen their heyday. In a nutshell, this means, especially for private equity companies: more banks involved, smaller credit volumes and more security! Not a bad new formula for the economy, in my view.

Reforming the financial system will therefore lead to structural change overall, which will affect private equity firms not exclusively, but particularly noticeably. As always, this creates new challenges as well as new opportunities. In the following, I will mainly focus on the new opportunities that I believe are opening up in the single European market.

4. Where do we stand in terms of regulation of the private equity industry?

Before I start, let me say that the European Union is a pioneer in the regulation of alternative investments! The European Directive on Alternative Investment Fund Managers (AIFM) has now been passed and is to be the regulatory framework for alternative investments in the European Union from mid-2013 onwards. In the United States, private equity funds are also to be subjected to higher registration and transparency requirements, although the details of the Dodd-Frank Act, which was passed in the United States, on this issue are not yet known. I do not believe, however, that the United States will present any major new standards in terms of the surveillance and regulation of the private equity industry.

While the European AIFM Directive does go significantly further than the Dodd-Frank Act, it does not go too far, in my opinion. First, it outlines general requirements for all alternative investment fund managers. These core provisions include registration and information duties vis-à-vis the competent supervisory authorities, minimum capital requirements, disclosure requirements towards investors and targeted organisational and operational stipulations. Moreover, private equity fund managers will be subject to specific information duties when investing in a non-listed company. Second, asset stripping will, in future, be banned for a certain period after the acquisition of control – subjecting it to a "retention period". In a bid to strengthen the single European market, the AIFM Directive also introduces an EU passport allowing alternative investment fund managers to market alternative investment funds to professional investors throughout Europe.

In a single European market for financial services, a harmonised set of requirements is indispensable. Moreover, corporate governance and investor protection should be improved. The AIFM Directive makes an important contribution to all these points. As I have already explained, this does not only entail duties – it also creates large opportunities. For instance, the introduction of an EU passport further improves private equity funds' marketing options. Moreover, enhanced transparency is likely to strengthen investors' confidence in private equity firms. This could place the debate on private equity, often very emotional in the past, on a more rational footing.

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4 Macroeconomic Assessment Group, Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements, August 2010.

In summary: I believe that the AIFM Directive makes an important contribution to regulating alternative investments in the European Union. The benefits of the directive should far exceed the costs that regulation imposes on those involved. I am certain that your industry will adapt easily to the new rules and make the most of the resulting opportunities.

5. Beyond Basel III: the new regulations and the shadow banking system

Although the G20 reform agenda has largely been successfully implemented, there is still a long way to go before the international financial system can be compared with the transparent glass courtyard in which we find ourselves today. As a "guardian of financial stability", I am particularly interested in the "dark corners" of the financial sector: the "shadow banking system".

Before I start and by way of introduction, I would like to stress that bank-like transactions outside of the banking sector should not *per se* be regarded as a bad thing, even if this might be implied by the common – but in my opinion misleading – term "shadow banking system". There may well be advantages in certain activities being carried out by specialised enterprises rather than banks or in banks outsourcing these activities to them – provided the specialists are indeed better at managing the associated risks. The shadow banking system should therefore certainly not be treated with disdain or seen as criminal, nor should its activities be prohibited.

Rather, the objective is for financial supervisors to have at their disposal sufficient information on any activities which could jeopardise the stability of the financial system. Amongst others, stricter regulation of banks will provide them with an incentive to transfer activities or assets to less regulated areas. This must not mean that these risks move off supervisors' radar screen. It is therefore indispensable that the shadow banking system be monitored in addition to the regulated banking system. At this point, I would like to explicitly promote greater transparency. Of course, I am aware that more extensive reporting requirements entail higher costs; however, given the potential systemic risks emanating from the shadow banking system, I believe that such a price is more than justified.

In particular, those involved must provide insightful reporting and meaningful statistics. To date, the size of the shadow banking system could only be estimated based on the national accounts. This puts the size of the German shadow banking system – definitions are naturally difficult here, I will nevertheless make a cautious estimate subject to the usual reservations – at around 17% of the assets of the banking sector. However, this includes investment funds in general; excluding them, the figure would be less than 4%. In any case, its volume would be far lower than in the United States, where the shadow banking system is larger than the banking sector itself according to first estimates by the New York Fed.

Good oversight also makes it easier to check whether regulatory requirements are appropriate. The responsible bodies will not take action for action's sake; in my view, regulation is not intended to restrict market activity, but to contain risks to the stability of the financial system. This also means that we will prevent any flouting of the stricter banking regulations set forth in Basel III and the planned regulations for SIFIs. Comparable activities and risks must be subject to comparable regulation. After all, all market players benefit from greater financial stability.

What players are in the light, which in the shadows? The answer to this question is likely to be of particular interest to the present audience. However, the interested public is also demanding an answer to this question, and confusion and misinterpretation are commonplace. I would therefore like to take this opportunity to make a contribution to this ongoing debate and provide a basic classification of private equity. At the behest of the G20, the FSB is currently drawing up recommendations to monitor and regulate the shadow banking system. And this committee recently defined what that means, namely "*credit intermediation involving entities and activities outside the regular banking system*". This credit intermediation can involve non-banks such as special purpose vehicles and money market funds. However, the definition also comprises activities such as, for instance, securitisations. It is my firm conviction that this does not include the private equity business model in its pure form. This is quite obvious in my opinion, as private equity companies provide equity capital. It is also worth mentioning that the situation is very similar for sovereign wealth funds if they invest in participating interests in enterprises, but in return provide equity rather than debt.

In a nutshell: whether an enterprise or a fund is classified as belonging to the shadow banking system depends not so much on its name as on its activities. For precisely this reason, some money market funds are included in the shadow banking system. In the run-up to the crisis, they, in particular, helped fund real estate loans in the United States by investing in asset backed commercial paper issued by special purpose vehicles to finance securitised real estate loans. Hedge funds, too, at least constitute links in the intermediation chain outside of the banking sector. After all, they gather funds and invest these in bonds and other credit instruments, including the associated derivatives. Consequently, as the distinction between hybrid private equity funds and hedge funds is blurred and the former partly operate under the umbrella of hedge funds, they too belong to the shadow banking system. This requires increased vigilance, as the number of structures established under their umbrella appears to be rising as first evasive action is taken.

Now, before you get uneasy – where regulation is concerned, I am generally opposed to ill-considered action for action’s sake, and this is no exception. When identifying, monitoring and, where appropriate, later introducing regulation, the primary objective is to contain those lending-related risks that are systemic and therefore relevant to financial stability. Future regulation should be strictly based on the degree of risk inherent in the activities of the respective financial corporations.

6. Summary

The general public may hardly have noticed, but those responsible for regulation have long since become active. For instance, parts of the shadow banking system have been subject to regulation for some time. Elsewhere, regulation has been improved since the onset of the crisis. One example is the introduction at EU level of the 5% retention rule for securitisations.

However, it is also already evident that merely illuminating specific areas of the shadow banking system and a one-off regulation drive will not suffice. After all, it is impossible at the current juncture to foresee all financial innovations and evasion strategies which may occur in the future, for instance in response to Basel III. Further adjustments will therefore be necessary. Even in a glass structure, light and shadow shift as the sun moves across the sky.

Thank you very much for your attention.