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CREATING LASTING VALUE

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Response to the Consultative Document "Revisions to he Standardised Approach for credit risk"

I. Introduction

The European private equity industry welcomes the opportunity to respond to the Basel Committee on Banking Supervision (the "BCBS") consultation "Revisions to the Standardised Approach for credit risk".

The private equity (including venture capital)[1] industry plays an important role in delivering smart, sustainable and inclusive growth that creates jobs and enhances the long-term competitiveness. This role partly depends on the relationship of the private equity industry with banks and therefore we would encourage the BCBS not to ignore the benefits this relationship can bring.

Banks remain an important part of the investor base of the private equity industry. Over the past six years for which data is available (2007 – 2013), banks accounted for more than 10% of all funds raised by the European private equity industry and through this asset class have invested €28bn in a broad range of different types of companies across the whole economy. More than 87% of private equity backed companies are small to medium sized enterprises ("SMEs"), which constitute the backbone of the economy.

We see no justification why the BCBS suggests such a significant change in the risk weighting for private equity funds and we are concerned that it may have a negative impact on the private equity industry and ultimately on the wider economy.

II. General presentation of private equity

We believe it is crucial to bear in mind the unique characteristics of private equity when determining the most appropriate risk weight for banks' investments into this asset class.

Institutional investors (like banks but also pension funds, insurers and funds of funds) typically gain exposure to private equity by investing in a portfolio of funds, which is diversified by vintage year, geography and stage of investment from early stage venture capital and growth equity, up to the largest buyout funds.

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[1] The term "private equity" is used in this paper to refer to all segments of the industry, including venture capital. The term "venture capital" is used in specific contexts where there are issues that relate particularly to this segment.

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Private equity is a long-term investment, which takes time to mature. Fund structures in private equity have been specifically designed to reflect this long-term characteristic. 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.

Funds are usually structured as closed-end vehicles with 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. They are not designed to be traded like a liquid asset, or for investors to be able to redeem their investment during the life of the fund, indeed this is typically expressly excluded by the legal agreement, which governs the management of the fund. The terms under which an investor can sell their position on the secondary market to another investor are limited and strictly governed by the terms of the fund's legal agreement. The EVCA risk measurement guidelines cover this topic in more detail (see below).

The fund manager draws down from this capital pool of commitments to fund the equity investment (often controlling) in a diverse range of portfolio companies over the course of the fund's investment period (typically 5-6 years of the fund's life). As the fund realizes its investment in each portfolio company the proceeds are promptly distributed back to the limited partners.

The fund manager seeks to increase the value of the portfolio companies through long-term active ownership management. Active management in the context of a private equity fund's investment typically means being active members of the board of the company and working with the management team, outside the formal board meeting cycle, on a variety of operational aspects of the business. This includes contributing to the development and implementation of the business strategy, recruitment of key members of the management team and helping management build a sustainable business beyond the period in which the private equity fund is invested.

An investor's average net invested capital (or capital at risk) is measured by the paid-in amount minus distributed capital. As funds typically start making distributions to investors before having drawn down and invested the entire commitment, the capital at risk is invariably much lower, on average, than the investor's overall legal commitment to the fund. In addition, proceeds from realizations can be used to fund that part of the investor's commitment still to be drawn down.

Studies show that in a normal market environment the maximum proportion of committed capital at risk during the life of a fund is only around 60% of the commitment made by the investor. In extreme scenarios, this number can reach up to 85%, but this would be untypical.

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III. Comments

The consultative paper on the Revisions to the Standardised Approach for credit risk seeks to reduce mechanistic reliance on external credit ratings, increase granularity, strengthen the link between the standardised and the Internal Rating Based (IRB) approaches and enhance comparability of capital requirements across banks.

The current BCBS standards allow banks to apply a risk weight of 150% for their investments in private equity funds if they use the standardized approach to calculate their capital requirements. We understand that the proposed revisions to the standardised approach intend to align the treatment of equity exposures with the treatment under the IRB and do not anticipate maintaining the 150% risk weight for higher risk categories such as private equity or venture capital.

Moreover, among other things, the paper suggests that: "equity holdings that are publicly traded shall receive a 300% risk weight and all other equity holdings shall receive a 400% risk weight". One can infer from this suggestion that under the revised regime private equity will fall within the 400% risk category.

Given that banks remain an important part of the investor base of private equity we fear that the proposed changes may have negative implications for our asset class and more importantly for the supply of capital to the real economy and SMEs.

We are concerned that such a significant increase to the risk calibration for private equity funds is proposed without any prior and proper evaluation of its potential consequences. The BCBS paper does not provide any solid, technical arguments explaining why such a change to the risk weighting is necessary or what has changed about the asset class that would justify such an increase. We also have difficulty understanding the risk management rationale for such a significant shift in the risk calibration of private equity funds.

We believe that it is unfortunate that the consultation paper does not provide any information clarifying why the BCBS has concluded that the 150% risk weight is no longer appropriate for private equity funds. The paper does not explain either what has led the BCBS to the conclusion that 400% is the most appropriate risk weight for this asset nor what methodology has been used to calculate it.

We are convinced that a proper impact assessment should be carried out in order to evaluate potential consequences of the proposed changes and if necessary present the advantages and disadvantages of different alternative choices. All those stakeholders potentially impacted by the revised approach should be given clear evidence regarding the need to take any particular action.

We feel that the BCBS is at risk of taking an arbitrary decision that would increase the risk calculation for banks that invest in private equity, thereby

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making it a less attractive asset class. This, we believe, goes against the objective to find ways of encouraging institutional investors (including banks) to invest more in long term investments, such as private equity.

IV. Studies on risk of private equity and EVCA's working groups

Many research studies have shown evidence that the risk in private equity can be managed very well and is very small in the long-term. Independent research shows that an investor not exposed to funding risk and holding a diversified portfolio of more than 30 funds has a risk of zero of losing any capital in 99% of the cases when holding it till maturity.

We have also developed practical and state-of-the art risk measurement guidelines for investors in the asset class private equity over 10 years. Experienced practitioners and academics produced the "EVCA Risk Measurement Guidelines", published for the first time in 2011.

The EVCA Risk Measurement Guidelines provide guidelines for sound and sensible risk measurement systems for investors in private equity. Here a concept has been developed which shows investors how to reduce their risk through appropriate management.

- The EVCA risk measurement guidelines introduce the concept of the "funding test" for investors. This funding test checks if an investor is able to pay all the future potential capital calls arising from its investment; including in difficult times. If this is the case, the risk an investor faces is very limited.

- Even if there is no redemption right included in a fund commitment, if an investor wishes to sell its private equity fund investment that can be done on the secondary market. The EVCA Risk Measurement Guidelines show that one needs to differentiate between an LP who does *not* meet the funding test and therefore will only be able to get rid of the undrawn commitments and an LP that *meets* the funding test and therefore will only trade at a 'fair value' (i.e., the fund's present value).

- Under this assumption, the risk of a private equity investment is very limited in the long-term and, hence, at a very low absolute level.

The EVCA has also carried out its own work that is relevant to this debate, particularly during the passage of the EU's Solvency II legislation.

In this context the EVCA research paper "Calibration of Risk and Correlation in Private Equity" developed a new index methodology, which reflects the specific characteristics of the asset class. The aim was to enable a way of better evaluating the real risks faced by investors when investing in this illiquid asset, which does not have the characteristics of a daily traded asset, such as public equities. The calibration methodologies developed are applied to two of the

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several, widely available, private equity benchmarks which are typically used by investors in private equity funds. The highlights of the approach can be summarized as follows:

- The study develops a new Private Equity Index based on changes of the net asset value (NAV) adjusted by cash flows. Making this cash flow adjustment and incorporating it in the calibration is crucial for capturing the true risk characteristics of private equity.

- The calibration methodology presented in this paper has been run on two databases, each containing almost two thousand private equity funds. This helps ensure the robustness of the results.

- The new approach more appropriately reflects the characteristics of private equity as an asset class, such as the illiquidity and the limited partnership closed-end fund structure. Hence, the proposed approach captures the risks of private equity for investors much more adequately as it takes into account the specifics of the asset class.

- In addition to the quarterly base index, an expanded monthly index is calculated in the paper. Even if the NAV is only available on a quarterly basis, this approach interpolates the values in-between and calculates the risk parameters based on this more volatile index.

- These results are supported by a second analysis, which is based mainly on cash flows. Applying the cash flow based method, it can be shown that the lower risk weighting is justified and appropriately reflects the risk. As the industry believes that the long-term risk of private equity is the most important one, the results of such an analysis are presented.

- Depending on the calibration method and the data base used, the shocks for the asset class, and hence the standard risk weighting for private equity, are between 20% and 30%.

V. Conclusion

We are concerned that the revised approach to the treatment of banks' investment into private equity funds has not been appropriately assessed and analysed. If implemented as now proposed, there is a meaningful risk of a negative impact on the private equity industry and ultimately on the wider economy.

We encourage the BCBS to reconsider its approach; to undertake a fuller analysis of the implications of different scenarios; to explain the reasons behind and evidence to justify and change; and to develop a solution that better takes into account the specificity of private equity funds.

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The EVCA strongly recommends adjusting the proposed stand-alone calibration for private equity in order to adequately reflect the true risk of private equity and the long-term nature of the asset class. Similar to the conclusion EU legislators reached in the Solvency II context, we would propose that for the standardised approach private equity is put in the same risk category as equity.

We would welcome the opportunity to engage with the BCBS in order to further explain the view of the industry and provide further information on this subject to assist in ensuring the adverse consequences of the BSBS suggestions are avoided.