17 March 2016

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

Response to the Consultative Document "Identification and measurement of step-in risk"

I. Introduction

The European private equity industry welcomes the opportunity to respond to the Basel Committee on Banking Supervision consultation *"Identification and measurement of step-in risk"* and appreciates the fact that the Committee has chosen to seek feedback on the proposed approach before finalising the specifics of its implementation.

The private equity industry plays an important role in delivering smart, sustainable and inclusive growth that creates jobs and enhances long-term competitiveness. This role partly depends on the relationship that our industry has with the banking sector. When banks become involved in private equity, they might do so in a number of different ways such as investing their own capital in the asset class, providing short-term credit facilities for bridging purposes to funds or lending money to portfolio companies for acquisitions and development.

In light of the above we would like to ensure that banks will continue to be able to provide necessary services to the private equity industry as well as to companies it invests in and that this valuable relationship is not undermined. We are concerned however that the proposed framework, and the definition of 'sponsor' in particular, might have some unintended consequences for the asset class and its relationship with the banking sector.

Moreover, given that for EU Member States the implementation of the Basel Committee's standards comes through the Capital Requirements Directive, which captures not only credit institutions but also investment firms, the proposed approach might in due course have implications for EU investment firms, including investment managers who are amongst our membership. We appreciate that the Basel Committee has no responsibility for any future steps that the European Commission and the EU's co-legislators in the Council and Parliament might take to extend the proposed approach to step-in risk from banks to non-bank investment firms. But this is important background and context for the comments that we make below.

In this response we do not address all of the detailed questions in the consultation paper but have focused solely on those aspects of the consultation which are of particular importance to our asset class.

II. General presentation of private equity

Private equity takes a long-term approach to investment and its fund structures 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. This is to enable the underlying companies in which investments are made to have the time and potential to grow and develop. 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 redemption during the life of the fund is typically expressly excluded by the legal agreement which governs the management of the fund. Although a secondary market can exist, the terms under which an investor could sell their position on the secondary market to another investor are limited and strictly governed by the terms of the fund's legal agreement, including requiring the consent of the fund manager.

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

The fund manager seeks to increase the value of the portfolio companies through long-term active ownership. Active ownership in the context of a private equity fund's investment typically means being active members of the board of the company, but also working with the management team outside the formal board meeting cycle on a variety of operational aspects of the business as decided by the board. 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.

III. Comments

The Basel Committee's proposed framework aims at identifying, assessing and addressing step-in risk, which is potentially embedded in banks' relationships with other entities which operate in the capital markets. The consultation paper defines "step-in risk" as *"the risk that a bank may provide financial support to an entity beyond or in the absence of any contractual obligations, should the entity experience financial stress"* and the Committee's approach is focused on identification of unconsolidated entities to which a bank may provide financial support, in order to protect itself from any adverse reputational risk stemming from its connection to those entities.

The paper also explains that the concept of 'sponsorship' is a key indicator in identifying step-in risk and provides that: *"a bank would generally be considered a sponsor and, in turn, an originator if it, in fact or in substance, manages or advises the programme, places securities into the market, or provides liquidity and/or credit enhancements".*

Given that the above definition of ‘sponsor’ was originally introduced in the Basel framework in relation to bank securitisation activity we feel that it might not be appropriate to apply it in a much broader context and use it for the purpose of developing rules around step-in risk. We fear that this definition may not be targeted enough to take account of those specific relationships that banks have with entities such as funds and fund managers and therefore might unintentionally catch institutions that in fact do not entail any step-in risk.

According to the consultation paper, the definition of sponsor contains three different elements of a sponsoring firm’s relationship with the sponsored entity: a) decision making (management and/or advice), b) operations (placing securities into the market) and c) financial support (provision of liquidity facilities or credit enhancement).

While the definition of sponsor indeed talks about capturing situations in which a bank ‘places securities’ this concept seems to be dropped in the rest of the framework and as such the paper gives rise to some degree of uncertainty about how this element should be interpreted and taken into account in the identification of step-in risk.

This is important because many private equity fund managers choose to use the services of third party professional placement agents to enhance their fundraising capabilities. The role of the placement agent is to identify prospective investors, assist in the development of a fund marketing strategy and effect introductions between the investors and the fund manager.

The placement agent typically receives a fee, which may be structured as a percentage of the funds introduced. The placement agent typically has no role in the closing of the fund and certainly does not underwrite commitments. The function can be distinguished from the role of an investment bank in placing securities as part of corporate finance activity. In the private equity market, placement agents may include banks and affiliates of banks (although many are independent). In all cases, however, the role of the placement agent is simply to act as an intermediary to introduce the fund manager to prospective investors. We firmly believe that this relationship does not expose banks to any step-in risk.

We therefore do not see any justification for this relationship to be included in the scope of the proposed framework. We invite the Committee to introduce further clarity around the concept of ‘placing securities’ and ensure that banks acting as pure third party placement agents (as they do in the context of private equity fund raising) would not be caught by the definition of ‘sponsor’ in respect of their client's private funds.

The definition of ‘sponsor’ raises another key question which is whether the concept of ‘credit enhancement’ catches ordinary arm’s length lending. We understand that in a securitisation context, credit enhancement involves giving additional comfort to participants in the securitisation that their securities will pay out. However, that nuance might be lost when this term is used in a broader context and there is a risk that ordinary arm’s length lending could also be caught by the concept of credit enhancement as currently proposed.

Our concern arises in part because the descriptions of items 4 and 5 in the table of primary indicators (page 14 of the consultation document) seem to be particularly broad. We fear that it could be inferred that a bank which is the sole provider of a fund-level equity call bridge facility (for example) and which has no-decision making authority over the fund nor any other relationship with the fund could nevertheless be caught by the proposed approach.

An equity call bridge facility is a loan facility used in the private equity industry to better manage cash flows between investors and a fund. When a manager is ready to make an investment into a target company commitments to that private equity fund are typically drawn down from investors by the manager with 14 – 28 days notice.

As the exact date of the closing of an investment in an underlying company is not known with this degree of advance noticebridge facilities are used to enable the investment in the underlying company to be completed in a timely fashion. A draw down (or call) notice for the exact amount needed to repay the amount borrowed to complete the investment is then sent out promptly to investors. The bridge facility is typically secured on the uncalled commitments of investors. The borrowing facilities are agreed with the bank for the duration of the life of the fund, but the actual borrowing is typically limited in time and in amount. We suggest that exposures of this type do not give rise to any concerns from a systemic risk or macro stability perspective.

We believe that this type of bank exposure was not intended to be caught by the proposed framework and for this reason we hope that the Basel Committee can provide further clarity around the concept of 'credit enhancement' ensuring that the provision of bridge financing to private equity funds is not included among those cases that could entail step-in risk.

A similar concern arises around arm's length bank lending to private equity fund-backed special purpose vehicles, which are used to acquire the equity stake in private equitytarget businesses. Because of the apparent breadth of items 4 and 5 in the table of primary indicators (page 14 of the consultation document) we are concerned that a bank which might be the sole lender to such acquisition SPVs, but which has no-decision making rights in relation to the fund nor any other relationship with the fund, could be considered to have step-in risk. We do not think that this can be intended and we hope that this issue might also be clarified.

IV. Conclusion

As explained above, we are concerned that the proposed framework may have some unintended consequences for our asset class. If implemented as now proposed, there is a risk of negative implications for banks' relationships with the private equity industry and their ability to provide certain banking services. This risk mainly stems from the ambiguity over the concepts of 'credit enhancement' and 'placing securities into the market'. As currently proposed the definition of 'sponsor' may capture bank activities that we believe do not entail any step-in risk and should not be caught by the Basel Committee's framework.

We encourage the Committee to review its approach and ensure that the definition of 'sponsor' is properly targeted to the situations and activities that expose banks to step-in risk and as such should be captured by the proposed solution.

We stand ready to discuss our position in further detail and provide necessary information on our asset class to assist in ensuring that the Committee's approach does not have any unintended adverse consequences for the private equity industry.

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.

For more information please visit www.investeurope.eu