European Private Equity &
Venture Capital
Association

EVCA's Comments on the Third Consultative Paper (CP3) released by the Basel Committee

EVCA welcomes the further opportunity offered by the Basel Committee to comment on its third consultative paper in respect of the proposals for a New Basel Accord (Basel II). The comments below follow the release of two other documents sent earlier to the Basel Committee[1].

EVCA would like to take this opportunity to reiterate its concerns in respect of the following:

- **Banks play a crucial role in financing European companies (mainly SMEs) by providing them with equity through private equity and venture capital houses.**

- **The current Basel II draft could lead to a significant retreat by banks from private equity and venture capital funds due to the proposed changes in risk weightings for assessing business risk.**

- **No quantitative assessment is publicly available regarding the exact impact of the proposed regulatory capital increases on private equity and venture capital. In short, there is a real risk that the current Basel II draft would not only harm the private equity and venture capital industry, but also significantly reduce annual flows of equity finance available to EU companies by between €5bn and €10bn[2] leaving them at a global competitive disadvantage.**

[1] The first document, dated February 2002, can be downloaded at:
http://www.evca.com/images/attachments/tmpl_16_art_2_att_140.pdf
The second document, dated January 2003, can be downloaded at:
http://www.evca.com/images/attachments/tmpl_16_art_7_att_250.pdf

[2] Annual Survey of Pan-European Private Equity and Venture Capital Activity, 2003 Yearbook, EVCA/PricewaterhouseCoopers

- **The risk weightings currently proposed for the industry do not correspond to business realities. EVCA urges the Basel Committee to ensure sufficient flexibility in its Accord so that by its implementation in 2007, the most recent risk models available are used.**

- **EVCA urges National Supervisors not to increase the risk weight for private equity and venture capital as stated in the Standardised approach.**

- **EVCA urges the Basel Committee to amend the paragraphs related to Grandfathering (§236, CP3, p. 49) in order to include positions taken until the date of implementation (end 2006) and not the date of publication of the final Accord.**

EVCA considers that more time is needed to ensure that standards not only meet the Basel committee's aims of fostering improvements in Banks risk management and risk assessment capabilities, but also fully correspond to the changing business realities of company financing.

EVCA remains, as ever, open to discuss these comments and can be contacted via the address below:

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EVCA's Comments

The role of Banks in European Private Equity and Venture Capital

Banks play a crucial role in financing European companies (mainly SMEs) by providing them with equity through private equity and venture capital houses.

The following table shows that banks are the origin of one quarter of all funds raised by private equity and venture capital houses in Europe. In 2002, some

8,000 companies received finance from European private equity and venture capital entities. Furthermore, over *80%* of these investments were in firms with fewer than 200 employees. The support of such businesses is an essential element of a dynamic and growth-driven economy.

Table 1 also shows that for ten European countries, as a total percentage of funds raised by private equity and venture capital houses, funds raised from banks are equal to or above 30%. These countries include the Netherlands (30%), France (30%), Germany (35%) and Spain (41%). The percentage is highest in Italy, where banks account for 52% of the total funds raised by local private equity and venture capital houses. As a result, some European countries risk being disproportionately affected by the current Basel II draft.

Table 1: Banks as a major source of funds for private equity and venture capital houses (in €m)

	Total Funds Raised by PE/VC houses (1998/2002)	**Amount coming from Banks**	**% of total raised**
Italy	9,486	4,901	52%
Austria	855	412	48%
Czech Republic	573	275	48%
Portugal	459	192	42%
Spain	4,627	1,892	41%
Hungary	272	111	41%
Greece	573	230	40%
Germany	17,158	6,026	35%
France	25,861	7,849	30%
Netherlands	6,922	2,061	30%
Europe	**161,312**	**38,175**	**24%**
Belgium	2,769	598	22%
Ireland	1,089	216	20%
United Kingdom	71,176	11,406	16%
Denmark	1,863	286	15%
Switzerland	2,684	386	14%
Poland	1,209	171	14%
Iceland	196	27	14%
Finland	2,690	276	10%
Sweden	8,074	746	9%
Slovakia	17	1	8%
Norway	1,799	117	7%

Source: EVCA/PricewaterhouseCoopers (Yearbooks 1999-2002)

The current Basel II draft could lead to a significant retreat by banks from private equity and venture capital funds due to the proposed changes in risk weightings for assessing business risk (see below).

This could deprive European companies (mainly SMES) of an annual flow of equity finance of between €5bn and €10bn[3]

EVCA comments on Regulatory Capital

In summary, the new Basel Accord foresees a significant increase in the regulatory capital required under both the Standardised and the Internal Rating Based approaches:

- Standardized approach: national supervisors may decide to apply a risk weight of 150% or higher (i.e. regulatory capital ratio of at least 12%) to private equity and venture capital finance

- Internal Rating Based approach: a 400% risk weight is foreseen for private equity and venture capital in the simple risk weight method (§315 - Market-Based approach, CP3, p.62) and a floor of 300% set in the Internal Models method (§318, CP3, p.63) and in the Probability of Default/Loss Given Default (PD/LGD) approach (§323, CP3, p.64). In other words, private equity and venture capital finance will be subject to a regulatory capital requirement of at least 24% but up to 32%.

It should be reminded here that the current Basel I Accord contains a regulatory capital requirement of 8%.

However, at present, no quantitative assessment is publicly available regarding the exact impact of these proposed regulatory capital increases on the availability of private equity and venture capital.

The Basel Committee concedes that relatively few banks completed the IRB approach in the Quantitative Study n°3[4], leaving no real opportunity to (really) gauge the true impact of the new rules.

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[3] Ibid

The impact of an increase in regulatory capital requirements will ultimately depend on the relationship between the new **regulatory capital** (ratio imposed by the supervisors) and the level of **economic capital** (ratio fixed by the banks themselves). If the new regulatory capital requirement is lower than the current economic capital, the potential for any negative impact on private equity and venture capital financing for companies will be reduced. **However if the regulatory capital exceeds the economic capital levels, a massive reduction in finance provided by banks to the industry will occur, with the net losers being European businesses.**

EVCA is not aware of any information released by the Basel Committee to the public on this issue. However, informal contacts between EVCA and key players suggest that the new regulatory capital requirements will exceed the economic capital of a number of several large banks in respect of private equity and venture capital investments. Further investigations should therefore be undertaken in this area.

EVCA urges the Basel Committee to ensure sufficient flexibility in its Accord so that by the time of its implementation in 2007, the most recent risk models available are used, not those prevailing in 2002. This will avoid penalising the private equity and venture capital industry on the grounds of a lack of impact assessment.

In the current draft of the New Basel Accord, the Loss Given Default (or LGD, which measures the proportion of the exposure that will be lost if a default occurs) for equities is set at 90%. However, an analysis of the business realities of 100 European liquidated private equity and venture capital funds (as of end 2002[5]) demonstrates that, when in a situation of default (i.e. when a fund has not returned the full amount of capital invested to the investors), investors received on average 44% of their capital. In other words, the results of this analysis set the LGD at around 56%, *significantly lower* than the 90% LGD for equities set in the current draft. This is not surprising as private equity and venture capital funds are diversified, and as private equity investors usually implement financing policies that provide them with a more senior ranking in case of bankruptcy on

[4] "Quantitative Impact Study 3 - Overview of Global Results", Basel Committee, 5 May 2003, http://www.bis.org/bcbs/qis/qis3results.pdf p.32.

[5] Source: Thomson Venture Economics. Note: studying liquidated funds allows for capturing the cash on cash returns, without relying on an estimated net asset value.

parts of their investments. The Loss Given Default stated in CP3 therefore overestimates the risk attached to the asset class.

Therefore, EVCA urges the Basel Committee to allow itself more time to develop a framework that will not only meet its requirements in terms of soundness of the banking system, but will also enhance the development of the European private equity and venture capital industry, whose crucial role in economic dynamism is widely recognised.

More time will also allow the development of relevant models to estimate the risk of exposure to the private equity and venture capital asset class. An ideal model could combine the risk factors of the underlying portfolio companies, of the fund and of the venture capitalist managing the fund. Although ideal, the feasibility of such an approach is problematic as the degree of diversification gained by a small number of investments in private equity and venture capital funds leads to a portfolio characterised by indirect stakes in several tens of companies. Therefore, models could be developed taking into account the risk of a specific fund. The European Investment Fund, Fitch Ratings and Standard & Poor's[6] have initiated preliminary work in this area. All these approaches attempt to model the timing and level of future cash flows of the funds taking into account risk factors such as the track records of the venture capitalists, stage focus (i.e. early or later stage), vintage year, geographical diversification, industry diversification, and comparisons of cash flows.

EVCA urges the Basel Committee not to set a 300% floor for equity holdings.

A 300% floor will be detrimental to the development of risk models for private equity and venture capital by banks. The arbitrary floor ratio in the current draft is not linked to business realities, and is inadequate in respect of existing default assessment information.

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[6] [5]"Risk Model for venture capital fund", Tom Weidig, Social Sciences Research Network. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=365881, 2002; "Rating Private Equity CFOs: Cash Flow Benchmarks", Special report, Structured Finance, CDO Research, Lily Cheung, Chris Howley, Vivek Kapoor, Andrew Smith, Standard & Poor's, 2003; "Going Public with Private Equity CFOs, Structure Finance, Credit Products Criteria Report, Michael Moise, Michael Romer, Michelle Galvez, Richard Hrvatin, Steve Lee, Elizabeth Koo, Fitch, 2002.

Furthermore, the floor goes against the aims expressed by the Basel Committee that "an improved capital adequacy framework is intended to foster a strong emphasis on risk management and to encourage ongoing improvements in bank's risk assessment capabilities"[7].

EVCA urges National Supervisors not to increase the risk weight for private equity and venture capital as stated in the Standardised approach

EVCA strongly advises national supervisors to carefully gauge the impact of an increase in the risk weight as the Basel Committee suggests for the standardised approach (§53, CP3, p.13). As mentioned above, the impact of the New Basel Accord on the European private equity and venture capital industries remains undocumented. In the face of such a high degree of uncertainty, national supervisors should not increase the risk weight as suggested by the Basel Committee in the CP3.

Leaving the risk weight at the levels suggested by the Basel Committee for the Standardised approach will also have an impact on banks following the Internal Rating Based (IRB) approach who fall under the remit of the Materiality (§328, CP3, p.64) or Grandfathering (§236 p. 49) clauses. These clauses allow banks who have adopted the IRB approach to follow the Standardized approach for equity holdings if they represent less than 10% of tier 1 and tier 2 capital (Materiality clause) and for equity holdings held at the time of the publication of the final Accord for a period of ten years (Grandfathering clause).

EVCA urges the Basel Committee to amend the paragraphs related to Grandfathering (§236, CP3, p. 49) in order to include positions taken until the date of implementation (end 2006) and not the date of publication of the final Accord.

As it is certainly not the intention of the Basel Committee to prevent banks from investing in the private equity and venture capital asset class, EVCA would recommend implementing the revision of §236 as mentioned above in order to provide the parties concerned with a clear and specific deadline.

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[7] "Overview of the New Basel Capital Accord", Basel Committee, April 2003, §3, p.2