



18 March 2019

Dear Chairman Randal Quarles,

Invest Europe, the association representing the European private equity industry, appreciates the opportunity to provide feedback for the Financial Stability Board's (FSB) evaluation of the effects of financial regulatory reforms on SME financing.

While we are not in a position to respond to all individual questions raised by the FSB, we hope that our contribution describing the role our industry plays in providing capital to SMEs will feed into the broader FSB examination of the effects of post-crisis reforms on financial intermediation. As we are a European association, our comments are concentrated on the specific EU rules and initiatives undertaken by European policymakers which, directly or indirectly, impact our members as providers of capital to the companies they support.

### ***Role of private equity***

Private equity connects investors from across the world - from large institutions to smaller but still sophisticated investors - with businesses that are looking not only for equity investment but also for the operational guidance and assistance that a private equity manager can bring. Investments into portfolio companies are held for an average of six years, enabling private equity to develop successful, sustainable companies. It is this combination of patient capital and active management that characterizes the private equity model and distinguishes it from other asset classes.

Every year private equity managers invest over 60bn EUR into 6800 companies. 87% of these companies were SMEs in 2017. Over the last decade a total of 560 billion EUR was invested by the private equity industry into 45,000 businesses, with approximately 7- 8 million people in Europe working in a private equity backed business. Most investments made by private equity firms are in SMEs and this proportion has been growing over the past few years (83% in 2015 and 87% in 2017 in number of companies). While venture capital funds focus on SMEs (98% in number of companies and 94% in amount invested), larger fund managers undertaking buy-out strategies also invest significantly in these companies (61% of the number of companies and 29% of the amount invested).

### ***Impact of investor regulations on SMEs***

Private equity funds provide capital to a range of companies, including start-ups and scale-ups, that otherwise would not have been able to receive funding directly from bank loans or from capital markets. On the other hand, they represent an attractive investment opportunity for institutional investors, such as pension funds or insurance companies, which are looking for real returns to better meet their long-term liabilities.

Banks are also a relatively important part of the private equity investor base. Over the past five years, banks provided €13.5 billion of capital to private equity funds, approximately 5% of the overall private equity fundraising over the same period. This is however significantly less than during the



previous 5-year period (2008-2012) where banks provided nearly twice as much capital (€ 23 billion) and represented a much more significant share (13%) of the overall fundraising.

In the European Union banks' investments into private equity are subject to specific risk-weights under the Capital Requirements Directive and Regulation (CRD/CRR), the EU legislation which translates the Basel framework into European law. Capital charges naturally shape banks' willingness to act as suppliers of capital to particular asset types, as they effectively change the anticipated net return of a particular investment. Although the CRD/CRR framework recognises that an investment in a fund has different characteristics than a direct investment in unlisted equity, the CRR capital requirements are determined by looking at each of the investments the fund has made (the so-called "look-through approach") instead of looking at the performance of the fund as a whole.

While we understand that Basel III is the main focus of the FSB evaluation, it is worth pointing out that the "look-through approach" does not apply only in a banking context. Other prudential regulations (such as Solvency II, the Directive governing capital rules for insurers in the EU) also requires financial institutions to look-through to the fund's underlying investments without considering that this is not how market players typically operate. Moreover, they often follow a "market-consistent" approach and this relies on using a "mark-to-market" model, which assumes the asset class in question has daily pricing. Such an approach requires that the market for the asset is both liquid and deep and private equity has none of these characteristics.

In our view, the way in which capital charges are calculated for private equity investments is fundamentally wrong and as a result overstates the real risk that institutional investors (such as banks and insurers) face when investing in the asset class. Consequently, this discourages them from committing capital to private equity funds and reduces the amount of capital these funds can in turn provide to SMEs, in particular those that are highly innovative.

#### ***Impact of other financial regulations on SMEs funding***

Private equity funds' ability to provide support to SMEs ultimately depends on the amount of capital they can raise from their local and international institutional investors. Therefore, any legislation restricting this ability has an impact on the capital they will be able to deploy in businesses and, as a direct consequence, may prevent European companies from accessing more diverse, stable and resilient forms of funding.

At European level, private equity fund managers are typically regulated by the Alternative Investment Fund Managers Directive (AIFMD) or can opt into the European Venture Capital Fund (EuVECA) Regulation which allow them to benefit from a passport and to market their funds across the EU, provided they comply with a series of requirements and reporting obligations. However, the cost of regulatory/marketing requirements, whether in the context of the AIFMD, EuVECA or national regimes, are - for many reasons - still considered by many private equity managers as a serious limitation to the cross-border distribution of funds.

The private equity industry is intrinsically global, with funds being raised from investors across the world and invested by managers in portfolio companies in Europe and beyond. Free movement of capital on a global basis (both into and out of the EU) is important both for portfolio companies based in Europe, which are the recipients of significant third country private equity investment, and for European institutional investors, who invest in third country private equity funds as part of their asset allocation and risk diversification strategies.



Against the above background, it is vital to ensure that the EU marketing rules are proportionate and tailored to the specificities of the private equity business model and that the national private placement regimes (NPPRs) continue to be available for fund managers that are not able to benefit from a passport. Equally, NPPRs should continue to be available for third country fund managers in the short and long term and co-exist with an efficient, uniform and commercially sensitive third country passport.

Meanwhile, legislation impacting other parts of the market can also have a lasting impact when they affect private equity exit routes, which allow them to convert the value of companies they support into benefits for their investors. This is the case for requirements set out in the Prospectus Regulation, which can create barriers when the fund manager wants to list a company it has grown on the public markets. Burdensome prospectus rules can, as a result, also act as a disincentive for private equity long-term investment into European companies as they make IPOs less attractive.

### **Conclusion**

Over the past five years, a lot of efforts have been put in place in the EU as part of the Capital Markets Union project to support SMEs financing. This includes the revision of the EuVECA framework (and the broadening of its eligibility requirements), the proposal to tackle barriers to cross-border distribution of funds (harmonising the definition of pre-marketing and limiting cases where Member States can impose undue fees and charges on fund managers) and smart financing initiatives to promote venture capital in the EU (such as the VentureEU programme).

However, more could be done at EU and international level. Supporting SMEs - and in particular start-ups and scale-ups - requires fund managers that operate in an environment which allows them to act as connectors between institutional (and sophisticated) investors and real businesses. Prudential regulation that appropriately assesses the risk of investment in funds and fund management regulation that allows, in particular smaller fund managers, to undertake seamless cross border marketing are both essential to attract more capital into the SMEs. As a global regulator, the FSB can play an important role in finding the right balance between maintaining financial stability and appropriate levels of investor protection, while fostering the global flows of capital that will allow the SMEs of tomorrow to thrive.

We remain at your disposal should you have any further questions.

Kind regards,

Michael Collins  
Chief Executive, Invest Europe

A handwritten signature in black ink, appearing to read "Michael Collins", written over the printed name and title.