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ASSOCIATION

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EVCA's Response to the Background Note of the Financial Stability Board on 'Shadow Banking: Scoping the Issues'

The European Private Equity and Venture Capital Association (EVCA) welcomes the opportunity to provide comments on the Background Note of the Financial Stability Board on 'Shadow Banking: Scoping the Issues', published on 12 April 2011.

EVCA remains, as ever, committed to an ongoing dialogue with policy officials and interested stakeholders, and welcomes any comment on its submission. In this respect, EVCA would particularly welcome the opportunity to meet with the Financial Stability Board to explain and discuss its thoughts in more detail.

Introduction

Several issues concerning financial sector regulation were identified at the November 2010 Seoul Summit (G20). During this Summit, the G20 Leaders highlighted in particular the importance of strengthening regulation and supervision of shadow banking given the systemic risks it can cause. The Financial Stability Board (hereafter "FSB") was asked to examine this issue and to develop recommendations. Consequently, the FSB released on 12 April 2011 a background note, in which it addresses the shadow banking issue.

We agree with the FSB that "shadow banking" can be broadly defined as "*credit intermediation involving entities and activities outside the regular banking system*". We do understand the need to consider regulation of the shadow-banking sector. While our firm understanding is that the activities of private equity firms/funds are not relevant from a shadow banking perspective, we deem it important to participate in the shadow-banking debate, stirred up again very recently at the annual World Economic Forum in Davos (January 2011). In our opinion, two main dangers arise regarding this debate:

- Firstly, there is globally an increasing confusion on this issue, in particular concerning the question of whether or not private equity firms are concerned by and/or involved in shadow banking. This confusion is seen in various press releases and articles. The press relays comments by bankers and regulators that do not distinguish between private equity and other types of activities, notably hedge funds. The press also regularly misunderstands how private equity funds operate and misinterprets regulators' statements on hedge funds as also relating to private equity.[1] Even some policy studies fail to distinguish between different types of funds in statements like the following: "*the shadow banking system may be taken as including hedge funds, private equity funds, structured investment vehicles known as SIVs, and sovereign funds, other than commercial banks subject to strict monitoring and regulations*".[2]

[1] See for instance Financial Times, *Shadow Boxes*, B. Masters and J. Grant, February 2011.
[2] *Global Financial Crisis, Hedge Funds, and the Shadow Banking System*, by Tokuo Iwaisako, Policy Research Institute, Ministry of Finance, Japan, Public Policy Review, Vol.6, No.3, March 2010, p. 347.

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- Secondly, some regulators increasingly concerned by shadow banking issues may aim at indiscriminately regulating all funds, not just those that may have activities that can be seen as credit intermediation, such as the larger hedge funds. Such a statement was made for instance by the French Financial Market Authority (AMF) in a March 2011 document in which it explains that the next major steps to be taken in the regulation of financial markets are managing systemic risks through the regulation of both hedge funds and other funds which are involved with credit intermediation. On the other hand, some commentators have made clear that shadow banking had nothing to do with private equity: Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, delivered on 12 May 2011, a speech concerning Private Equity and Basel III, in which he highlighted the necessity to regulate shadow banking while **pleading for a regulation strictly based on the risk level of the activities of the funds actually involved in credit intermediation.**[3]

- This debate shows, like the FSB background note on shadow banking, the need to better define and identify the risks inherent to shadow-banking activities in order to reduce and mitigate them.

- In this context, to avoid inappropriate and overly burdensome regulations being imposed on funds that do not engage in credit intermediation, it is critical not to lump private equity funds together with funds whose activities involve credit intermediation as well as high leverage and risk exposure.

In this context, the FSB background note aimed at more precisely defining shadow banking, setting out potential approaches for monitoring the shadow banking system, and exploring possible regulatory measures to address the systemic risk and regulatory arbitrage concerns posed by the shadow banking system.

The FSB background note attempts to define shadow banking by considering two elements: (i) "*the system of credit intermediation that involves entities and activities outside the regular banking system*" (emphasis added) and (ii) the risks created (systemic risks and / or regulatory arbitrage concerns) (emphasis added). It is worth underlining that a more precise definition of credit intermediation, clarifying the FSB position, would be most useful.

On the basis of this definition, only entities and activities whose business model involves extending credit (either directly or as part of a chain of credit intermediation) or facilitating its intermediation are included in the definition of shadow banking. These entities should be subject to regulation only insofar as important risks linked to maturity/liquidity transformation, flawed credit risk transfer and leverage are likely to emerge.

But the FSB background note and its broad definition of shadow banking leave much room for interpretation - and hence uncertainty. Indeed, the FSB does not explicitly exclude equity trading. The background note suggests that private equity activities may come within the scope of the shadow banking regulation insofar as they are linked to credit intermediation.

EVCA is intervening in this debate to help legislators and regulators distinguish clearly between different types of funds, The present paper explains that private equity fund activities do not constitute shadow banking and do not create systemic risk. To the extent that private equity funds invest in banks or entities engaged in credit intermediation, these entities can and should be subject to the same regulation as other companies engaged in similar activities.

[3] Dr. Andreas Dombret, *Private Equity und Basel III*, Speech delivered in Berlin, 12 Mai 2011, pp. 12-13.

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Response

1) Private equity fund activities are not caught by the shadow banking definitions

Private equity funds/firms and shadow banking have nothing in common: private equity firms do not operate in any shadow and they are not engaged in banking activities.

The De Larosiére report confirmed that private equity does not create systemic risk. There is not any lack of transparency – and hence any "shadow" aspect – in private equity activities. Private equity activities are further subject to stringent future regulations, found in the AIFM Directive. Chapter IV, entitled Transparency requirements, includes provisions imposing disclosure requirements on private equity funds, whether it be an annual audit report obligation (Article 22), a high disclosure standard regarding funds and their investors (Article 23), or more general reporting obligations (including liquidity and risk reporting – Article 24).

Furthermore, private equity funds are not engaged in the credit intermediation process and do not give rise to any maturity mismatch or systemic risks. These points are discussed in more detail below.

(i) Private equity firms are not part of the credit intermediation chain. Private equity firms, unlike many hedge funds, do not rely on short-term credit for their operations. Neither do they lend to financial system participants. Private equity funds' investments generally concern <u>highly illiquid equity securities</u>. While some private equity <u>acquisitions</u>, like any other corporate acquisition, involve borrowing (which is subject to credit review by the lending bank), the resulting debt is borne by the target's holding company and not by the private equity fund. Thus, the private equity fund cannot be described as being involved in credit intermediation. It should be noted that some private equity funds invest in debt securities. Again, however, this activity cannot be described as credit intermediation; such debt funds buy and sell debt securities just like any other investor. These funds are generally not involved in loan origination or the provision of credit, but merely invest in existing loans. As clearly explained in a Private Equity Growth Capital Council (PEGCC) submission to the US Secretary of Treasury in November 2010, "*private equity funds (including these debts funds) are <u>not a material source of credit to business</u>, and they are <u>not a source of credit at all</u> to consumers or governments*".

(ii) Private equity activities do not cause systemic risks or mismatch:

- Private equity funds have a long life (typically 10 years plus), are closed-ended and investors cannot withdraw their commitments from the fund at will, nor even on notice. Given the limited redemption rights at fund level, there is no potential maturity mismatch.

- Private equity funds' investments are diversified both geographically and among industries. Each portfolio company group has its own specific holding company. Each portfolio company group is managed independently, and private equity AIFs report their returns on a portfolio company-by-portfolio company basis. A portfolio company group backed by a private equity fund is not in any way responsible for or exposed – directly or indirectly – to the borrowings of any other portfolio company of the same fund. Therefore, <u>since</u> private equity <u>activities are diversified and</u> private equity <u>structures are not cross-collateralized</u> (they are silo-ed for each portfolio company), they do not give rise to systemic risks.

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- There is no deep interconnectedness between private equity firms and banks or other non-bank financial companies. As discussed below, the portfolio companies in which private equity funds invest do business with banks or non-bank financial companies, they do so as a part of their ordinary business. The fact that their shareholders include private equity does not make a private equity fund a credit intermediator.

2) **While private equity firms may invest in banks or other entities engaged in credit intermediation, these entities can and should be regulated directly based on the nature of their activities; the private equity fund's investment does not itself constitute credit intermediation.**

As noted, private equity funds' investments are diversified both geographically and among industries. Some private equity portfolio companies are active in regulated industries, including banking (such as Altor Fund III, a private equity fund, purchasing shares in Carnegie, an investment as well as private bank). If and when new regulations are adopted covering credit intermediation outside the banking system, any private equity portfolio company engaged in such activities will of course be covered by the new rules. For portfolio companies not engaged in such activities, subjecting them to shadow-banking regulation simply because they have a private equity shareholder would be discriminatory and create an unlevel playing field. In addition, whatever limitations are imposed as part of a new shadow-banking regulatory framework would be inappropriate to the business models of portfolio companies engaged in a wide range of non-financial activities.

3) **If certain private equity firms would start undertaking activities outside of their core activities as private equity manager and constituting shadow banking activities, the latter would be, as for any other firm, regulated and covered as such either by non-bank regulation or by bank regulation instruments or by any new "shadow banking" regulation.**

Markets in Financial Instruments Directive (MIFID) already works as a kind of safety net, covering most financial services, ranging from portfolio management, receiving and transmitting orders, dealing both on own account and on behalf of others, to investment advice and placing and (as an ancillary service) advice to undertakings on capital structure, industrial strategy and services relating to mergers and the purchase of undertakings, in each case assuming the service is done on a professional basis and in relation to a financial instrument.

Financial instruments include transferable securities negotiable on the capital markets, as well as interests in collective investment undertakings. This definition could be clarified as far as needed at the occasion of the next MiFID review if relevant to cover intermediation related financial services.

Even when looking specifically at proprietary trading, dealing on own account as a regular profession or business on a professional basis is regulated. And here again existing exclusions are being reconsidered under the MiFID Review.

More sectorial regulations could in any case also apply to shadow banking activities, such as all existing directives aiming at regulating banking activities..

Again, regulatory tools are there and can be improved as far as needed in order to cover so-called "shadow banking" activities, but whatever the type of firm dealing with such activities, this has nothing to do with any specific private equity management activity nor with its related AIFM Directive.

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