FRANCE INVEST

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France Invest's contribution to the European Commission's consultation on assessing the adequacy of macroprudential policies for NBFIs

France Invest fully supports the development of the CMU and the objective to foster retail participation to capital markets as well as the Commission's aim to ensure financial stability. In this context, we welcome the opportunity to comment on the Commission's consultation on assessing the adequacy of macroprudential policies for non-bank financial institutions (NBFIs).

We agree that NBFIs, and in particular venture capital and private equity (VC/PE), are a **source of financial diversification for investors and therefore resilience**.

VC/PE funds serve as a financing source for non-listed SMEs, often complementing bank financing. They provide long-term support and funding to help these companies grow and expand. Portfolio companies have various financing options available to them. Once VC/PE funds are no longer involved, they may opt for alternatives including initial public offerings (IPOs), investment from other VC/PE funds, or acquisition by strategic buyers, such as another company.

Our members are regulated entities which have to comply with robust regulatory frameworks, both at European and national level. In addition, **the funds they manage are governed by different sets of regulations**, again both at European and national level. We very much welcome that the Commission's intention is not to revisit recent legislative agreements and that it recognizes the progress made from an open-ended funds perspective through the recent review of the AIFMD and the need now to focus on its implementation.

It should be noted that our members manage capital on behalf of fund investors and that this capital is entrusted to depositaries. In case of failure of an asset management company, the management of the funds it manages can be transferred to another management company.

Currently, **a large majority of the funds managed by our members are closed-ended and marketed to professional investors** which invest over the long term. VC/PE fund managers raise capital from a wide range of sources, in particular from institutional investors such as credit institutions, insurance companies or pension funds. **These institutional investors are themselves covered by stringent regulations** and their investments into VC/PE are governed by strict mechanisms.

This being said, **"evergreen" funds**, offering greater liquidity to investors, are becoming increasingly popular, in particular as they cater for the liquidity requirements of retail investors. In this respect, **the AIFMD includes provisions on the management of the liquidity risk** by managers of open-ended funds, and RTS and

guidelines on this matter are under development by ESMA. In addition, funds which are granted the ELTIF label are regulated by the recently revised ELTIF Regulation, which includes specific obligations on open-ended ELTIFs and their liquidity risk management.

In addition, while VC/PE markets are generally less liquid, the development of **active secondary markets** and the significant increase in the vitality of these VC/PE secondary markets in the past few years should be underlined. For instance, the recently revised ELTIF Regulation introduces a matching mechanism that will provide some form of liquidity to investors in these funds.

We would like to highlight that **the VC/PE funds managed by our members are not substantially leveraged**. And, again, they have to comply with the strict rules of the AIFMD in this respect.

Last, it should be noted that the **maximum potential loss incurred by investors in the funds managed by our members is typically limited to the amount of their capital commitment** i.e. even if the fund's investments perform poorly, the investor's loss is limited to their committed capital, and they cannot lose more than this amount. Generally, they are not liable for any debts or obligations of the fund beyond their committed capital. Investors know their maximum risk exposure from the outset and are not liable beyond their agreed-upon commitment.

Key vulnerabilities and risks stemming from NBFIs

Question 1. Are there other **sources of systemic risks or vulnerabilities stemming from NBFIs' activities** and their interconnectedness, including activity through capital markets, that have not been identified in this paper?

"Key vulnerabilities stem from liquidity, leverage, interconnectedness as well as lack of consistency and coordination among frameworks across the EU".

No, we do not see any additional sources of potential systemic risks or vulnerabilities stemming from NBFIs' activities and their interconnectedness.

Question 2. What are the **most significant risks for credit institutions stemming from their exposures to NBFIs** that you are currently observing? Please provide concrete examples.

Risks for credit institutions stemming from their exposures to AIFMs and VC/PE funds are limited.

First, VC/PE funds are an important investment opportunity to many institutional investors, including credit institutions. They provide potentially higher returns and help enhance credit institutions' portfolios. They allow credit institutions to diversify their investment portfolios, reducing the overall risk by spreading investments across asset classes. In addition, **credit institutions typically invest in multiple VC/PE funds, which themselves invest in a diversified portfolio of companies**, across different sectors, geographies, and stages of business development. This multi-layered diversification helps spread the risk of any single investment failing.

Prudential legislation that applies to institutional investors reduces the risks for credit institutions stemming from their exposures to NBFIs such as VC/PE funds. By imposing capital requirements and other risk management measures, these regulations ensure that credit institutions are better protected against potential losses from their investments in these funds.

Second, banks may also lend to portfolio companies owned by VC/PE funds – but as this lending is legally made to an entity that is structurally separate from the fund, it is not different from lending to any other corporate entity. ECB Guidance on leveraged transactions limits the ability of banks to lend to companies owned by private equity.

Third, lending to VC/PE funds by credit institutions is very rare and limited, as these funds do not use debt to increase their returns at fund level.

Question 3. To what extent could the **failure of an NBFI affect the provision of critical functions to the real economy or the financial system** that cannot easily be replaced? Please explain in particular to which NBFI sector, part of the financial system and critical function you refer to, and if and how you believe such knock-on effect could be mitigated.

The risk of an AIFM or VC/PE fund failure impacting the delivery of essential services to the real economy or the financial system is limited.

The VC/PE industry is composed of a vast number of market players. In the event of default of an asset management company, the funds it manages are generally protected by regulatory and structural mechanisms which ensure the continuity and security of clients' investments, including the separation of the assets and the protection provided by a depositary. **The management of the funds managed by the defaulting asset management company can be transferred** to another management company, possibly with the intervention of financial regulators to facilitate this process and minimize any disruption. In other words, the bankruptcy of the asset management company cannot extend to the commitments of investors or to the investments of funds managed by the management company.

VC/PE funds serve as a financing source for non-listed SMEs, often complementing bank financing. They provide long-term support and funding to help these companies grow and expand. Portfolio companies have various financing options available to them. Once VC/PE funds are no longer involved, they may opt for alternatives including initial public offerings (IPOs), investment from other VC/PE funds, or acquisition by strategic buyers, such as another company. In other words, **the financing of divested companies can continue from other sources.**

The maximum potential loss incurred by investors in the funds managed by our members is typically limited to the amount of their capital commitment i.e. even if the fund's investments perform poorly, the investor's loss is limited to their committed capital, and they cannot lose more than this amount. They are not liable for any debts or obligations of the fund beyond their committed capital. Moreover, they are not liable for any debts contracted by asset management company on its own behalf. Investors know their maximum risk exposure from the outset and are not liable beyond their agreed-upon commitment.

Question 4. Where in the NBFI sectors could **systemic liquidity risk** most likely materialise and how? Which specific transmission channels of liquidity risk would be most relevant for NBFI? Please provide concrete examples.

Most of the funds managed by our members are closed-ended and as such do not pose significant systemic liquidity risks. Investors in these funds typically do not look for exit opportunities when making investments (as there is an understanding that value only comes at the end of the investment) and do not expect to see returns on their investments before the end of the life of the fund.

As for the semi-liquid funds they manage, which are mostly designed for the needs of retail investors, our members have to comply with the strict obligations set out in the AIFMD2 and ELTIF2 Regulation frameworks and are required to have robust liquidity risk management systems in place.

Question 5. Where in the NBFI sectors do you see build-up of excessive leverage, and why? Which NBFIs could be most vulnerable? Please provide concrete examples.

The VC/PE funds managed by our members are not substantially leveraged. Except some circumscribed exceptions, the use of debt is made at the level of the portfolio company.

The debt incurred by portfolio companies is legally and economically separated from the funds – and therefore should not be deemed as leverage. In other words, the borrowing at the level of each portfolio company has no bearing on the leverage of the fund (if there is any), as it is ring-fenced from any debt of the fund itself and of any other portfolio company supported by the fund. This legal and economic separation is an essential feature of the VC/PE model.

We would like to underline that the use of certain instruments, such as subscription credit lines, NAV facilities or collateralized fund obligations, which are used by some funds to ensure they can service their investors' interests in the best way possible, does not give rise to systemic concerns.

Currently, the use of NAV facilities in France is generally limited. These facilities are challenging to implement, particularly due to the complexity of their fiscal structuring. They are primarily utilized for reinvestment purposes rather than for anticipating asset sales. Investors tend to be hesitant about their use, favoring continuation funds that provide an opportunity for exit. Additionally, NAV facilities are temporary and are included in leverage calculations under the AIFMD.

Question 7. Considering the role NBFIs have in providing greater access to finance for companies and in the context of the capital markets union project, how can macroprudential policies support NBFIs' ability to provide such funding opportunities to companies, in particular through capital markets? Please provide concrete examples.

VC/PE plays an important role in providing much-needed funding and strategic support to SMEs that are not publicly traded. They provide these companies not only with capital but also with strategic support, growth and innovation. VC/PE firms provide an alternative source of capital that can help these businesses grow, innovate, and expand. They also offer strategic guidance, management expertise, and access to networks that can significantly enhance the operational efficiency and market reach of SMEs. Their funding is particularly crucial for startups and high-growth SMEs that need substantial capital for research and development, market expansion, and scaling operations. This type of investment is typically more patient and willing to take on higher risks compared to traditional lenders.

In our opinion, **macroprudential policies should enhance the flow of capital to VC/PE investments through setting appropriate prudential capital requirements** (i.e. recognizing the long-term nature and potential economic benefits of VC/PE), **alleviating costs** (i.e. assigning VC/PE lower risk weights or offering capital relief) **and encouraging long term investment** (i.e. making VC/PE more attractive to institutional investors).

This would contribute to increasing the allocation of institutional capital to VC/PE and, as a result, the funding available for non-listed SMEs. This would in turn foster economic growth, as the development of SMEs is often a key driver of innovation and employment, and encourage the diversification of institutional investors' portfolios.

Unmitigated liquidity mismatches and tools to mitigate risks in other open-ended funds (OEFs)

The liquidity mismatch in open-ended (or semi-liquid) VC/PE funds is managed using a combination of tools (LMTs - such as notice periods or gates - and liability management). As highlighted by the Commission, the new AIFMD2 and ELTIF2 frameworks will enhance the resilience of open-ended AIFs and in particular open-ended ELTIFs.

As explained, **our members and the funds they manage are subject to the recently updated AIFMD2 and ELTIF2 frameworks**, which will significantly enhance the robustness of the liquidity risk management of open-ended AIFs and in particular ELTIFs. Last July, the Commission released a delegated act specifying the requirements for an ELTIF's redemption policy and liquidity management tools, the circumstances for the matching of transfer requests of units or shares of the ELTIF, certain criteria for the disposal of ELTIF assets. We welcome the approach of ensuring permanent liquidity management, and not just in emergency or

liquidity crisis situations, which avoids the need for massive redemptions. Currently, ESMA is consulting on RTS and guidelines on Liquidity Management Tools under the AIFMD2 which will specify the characteristics, selection, activation and calibration of liquidity management tools for open ended AIFs.

We would like to reiterate here that, **if we fully agree with the Commission that the activation of an LMT should remain full responsibility of the manager, we strongly disagree with the Commission's proposal to empower the NCAs or ESMA to require the AIFM to select a specific LMT for a fund or cohort of funds.**

Link between liquidity mismatch and liquidity risks

Question 16. How can NCAs better monitor the liquidity profile of OEFs, including redemption frequency and LMTs, in order to detect unmitigated liquidity mismatches during the lifetime of OEFs?

Currently, **a large majority of the funds managed by our members are closed-ended and marketed to professional investors which invest over the long term**. Most VC/PE funds are therefore entirely out of any liquidity concern, as there is no possibility of runs.

VC/PE fund managers raise capital from a wide range of sources, in particular from institutional investors such as credit institutions, insurance companies or pension funds. **These institutional investors are themselves covered by stringent regulations** and their investments into VC/PE are governed by strict mechanisms.

This being said, evergreen funds, offering greater liquidity to investors, are becoming increasingly popular, in particular as they cater for the liquidity requirements of retail investors. Such semi-liquid funds often have a (semi) open-ended structure, which allows investors to invest and withdraw their capital under specific terms (e.g. specific intervals, subject to pre-agreed caps on how much capital investors can withdraw at any given time. notice periods for redemption requests…).

In this respect, **the AIFMD includes precise provisions on the management of the liquidity risk of open-ended funds** and RTS and guidelines on this matter are under development by ESMA. In addition, the ELTIFs managed by our members are regulated by the recently revised ELTIF Regulation, which includes specific obligations on open-ended ELTIFs and their liquidity risk management.

In addition, while VC/PE markets are generally less liquid, the **development of active secondary markets** and the significant increase in the vitality of these VC/PE secondary markets in the past few years should be underlined. For instance, the recently revised ELTIF Regulation introduces a matching mechanism that will provide an additional form of liquidity to investors in these funds.

Question 17. What is the data that you find most relevant when monitoring liquidity risks of OEFs?

The AIFMD already requires managers to report information on liquidity. This data should be the one used at EU level.

Question 19. On the basis of the reporting and stress testing information being collected by competent authorities throughout the life of a fund, how can supervisory powers of competent authorities be enhanced to deal with **potential inconsistencies or insufficient calibration between the LMTs selected by the manager for a fund or a cohort of funds and their assets and liabilities liquidity profile**? How can NCAs ensure that fund managers make adjustments to LMTs if they are **unwilling to act**? How could **coordination** be enhanced at the EU level?

If we fully agree with the Commission that the activation of an LMT should remain full responsibility of the manager, we strongly disagree with the Commission's proposal to empower the NCAs or ESMA to require the AIFM to select a specific LMT for a fund or cohort of funds. The authorities already have

a general power of control over the fact that the asset management company is acting in the best interests of its unitholders, and this power is sufficient to enable each NCA to ensure that the asset management company sets up and maintains operational LMTs in line with the level of liquidity proposed by the fund.

In any case, rules on LMTs should be adapted to the realities of different fund types, as rules that would not sufficiently be tailored could create risks of paralysis or runs (please refer to our contribution to ESMA's consultations on LMTs under the AIFMD2).

Question 21. [To asset managers] What difficulties have you encountered in measuring and monitoring liquidity risks and their evolution? Are there enough tools available under the EU regulations to address liquidity mismatches?

In our opinion, there are enough tools available under the EU regulations to address the liquidity risk of open-ended AIFs. The revised AIFMD2 offers a wide and harmonized range of liquidity management tools, from which AIFMs have to choose two. In addition, it allows these managers to put in place any other additional tool they may deem relevant (e.g. soft closures).

Excessive leverage

Open ended funds (OEFs)

Question 43. What are other tools than those currently available under EU legislation which could be used to contain systemic risks generated by potential pockets of excessive leverage in OEFs?

The VC/PE funds managed by our members are not substantially leveraged and do not make much use of synthetic leverage via derivatives positions. And, again, they have to comply with the strict rules of the AIFMD on leverage.

More specifically, article 25 of the AIFMD includes tools to deal with leverage and restricts the use of leverage. In addition, the Directive includes reporting requirements which provide supervisory authorities with a comprehensive view of the leverage used in AIFs.

It should be noted that **the debt incurred by portfolio companies is legally and economically separated from the funds** – and therefore should not be deemed as leverage. In other words, the borrowing at the level of each portfolio company has no bearing on the leverage of the fund (if there is any), as it is ring-fenced from any debt of the fund itself and of any other portfolio company supported by the fund. This legal and economic separation is an essential feature of the VC/PE model.

Question 45. While on average EU OEFs are not highly leveraged, are there, to your knowledge, pockets of excessive leverage in the OEF sector that are not sufficiently addressed? Please elaborate with concrete examples.

The VC/PE funds managed by our members are not substantially leveraged and do not make much use of synthetic leverage via derivatives positions. And, again, they have to comply with the strict rules of the AIFMD on leverage, as well as any additional regulation applicable at national level on the funds themselves.

Other NBFIs and markets

Question 47. Are you aware of any NBFI sector entities with particularly high leverage in the EU that could raise systemic risk concerns?

The VC/PE funds managed by our members are not substantially leveraged and do not make much use of synthetic leverage via derivatives positions. And, again, they have to comply with the strict rules of

the AIFMD on leverage, as well as any additional regulation applicable at national level on the funds themselves.

<u>Monitoring interconnectedness</u>

Question 52. Do you have concrete examples of links between banks and NBFIs, or between different NBFI sectors that could pose a risk to the financial system?

Overall, as financial institutions, VC/PE funds have limited direct financial exposures to other participants in the financial system. **The maximum potential loss for a VC/PE fund is limited to the amount of equity it has invested in a specific portfolio company**. Such failures have no bearing on other investments made by the fund because there is no borrowing across portfolio companies nor is there any recourse to the fund. In turn, **the maximum potential loss incurred by investors in the funds managed by our members is typically limited to the amount of their capital commitment** i.e. even if the fund's investments perform poorly, the investor's loss is limited to their committed capital, and they cannot lose more than this amount. They are not liable for any debts or obligations of the fund beyond their committed capital. Investors know their maximum risk exposure from the outset and are not liable beyond their agreed-upon commitment.

VC/PE funds allow institutional investors such as credit institutions to diversify their investment portfolios, reducing the overall risk by spreading investments across asset classes. In addition, credit institutions typically invest in multiple VC/PE funds, which themselves invest in a diversified portfolio of companies, across different sectors, geographies, and stages of business development. This multi-layered diversification helps spread the risk of any single investment failing.

Prudential legislation that applies to institutional investors reduces the risks stemming from their exposures to VC/PE funds. By imposing capital requirements and other risk management measures, these regulations ensure that institutional investors are better protected against potential losses from their investments in these funds.

Beyond fundraising, VC/PE funds are not directly intertwined with other financial market players:
- Because they are typically unleveraged, VC/PE funds do not engage in a significant amount of borrowing or trading in derivatives at the fund level and thus have limited counterparty exposure;
- VC/PE funds – even when two are managed by the same fund manager – are not exposed to each other as they neither pledge their assets as security nor guarantee each other's obligations;
- VC/PE funds do not rely on short-term credit for their operations.

<u>Supervisory coordination and consistency at EU level</u>

Enhanced coordination mechanism

Question 58. How could the currently available coordination mechanisms for the implementation of macroprudential measures for OEFs by NCAs or ESAs (such as leverage restrictions or powers to suspend redemption on financial stability grounds) be improved?

In our view, the mechanisms in place are sufficient.

Question 61. Are there other ways of seeking coordination on macroprudential measures and possibly of reciprocation? What could this system look like? Please provide concrete examples/scenarios and explain if it could apply to all NBFI sectors or only for a specific one.

We would like to warn against the possible unintended consequences of "one size fits all" measures. VC/PE is specific.

Contact

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About France Invest

Established 40 years ago, France Invest brings together venture capital, private equity, infrastructure and private debt teams based in France, as well as the associated professions which support them. Its membership currently counts roughly 440 management firms and 200 associate members.

Private equity supports unlisted companies for a fixed period of time and provides them with the equity capital, through the acquisition of minority or majority stakes in their capital, needed to finance growth and transformation projects. It supports the creation of start-ups (venture capital), participates in the growth and transformation of many regional SMEs and mid-caps (growth capital) and contributes to the transfer of companies (replacement capital).

France Invest's members represent one of the main growth drivers for the French and European economy and support a significant portion of employment in France and Europe. In 2023, French private equity and infrastructure players invested €31 billion in 2,700 companies and infrastructure projects. They raised €33 billion from investors, half of which abroad (just under one third at EU level excluding France), which will be invested over the next 5 years[1]. In addition to that, in 2023, private debt players (structures financing companies and infrastructure projects) invested €14 billion in 387 transactions and raised €10 billion that will finance new transactions in the coming years[2]. European companies, in particular start-ups and SMEs, are the main recipients of our members' investments. Over the 2017- 2022 period, over 330 000 jobs were created in companies backed by French venture capital and private equity[3].

In particular, during the pandemic, the venture capital and private equity industry has demonstrated its adaptability, supporting existing portfolio companies as and when needed, while continuing to invest in new businesses that require capital and operational expertise to grow.

[1] https://www.franceinvest.eu/activite-du-capital-investissement-francais-en-2023/

[2] https://www.franceinvest.eu/activite-des-fonds-de-dette-privee-en-france-en-2023/

[3] https://www.franceinvest.eu/croissance-et-creation-demplois/