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Invest Europe Response

EBA Regulatory Technical Standards on prudent valuations

Executive Summary

We respond to this consultation on behalf of the European private equity and venture capital industry. Our association represents private equity and venture capital managers across Europe as well as their investors, which include a large number of institutional investors including banks.

While the EBA standards cover a significant range of topics, our response focus on a specific area of the standards: the classification of the unlisted equities under the fallback approach (Article 7.4).

When drafting its final standards, we would call on the EBA to take into consideration the implications of its approach:

- first, the direct impact it could have on the valuation of some types of unlisted equities
- second, the indirect impact it could have on European capital markets if it is determined that, as pointed out by the EBA, valuations of unlisted equities can never be deemed prudent

While the first point could have significant consequences on the relationship between banks and private markets, the second would have a greater impact on private markets overall, as the EBA approach could create a precedent beyond the banking world.

In the response below we aim first at explaining to the EBA why an approach as punitive as the fallback approach does not really correspond to a prudent valuation of these assets (i.e.: why the EBA would significantly undervalue these assets and force banks to keep more own funds for no corresponding prudential benefit).

Second, we touch on the fundamental danger posed by the assertion that unlisted equities are necessarily never “prudent” – and the number of biases it ultimately creates at a time where private financing (including venture capital, private equity and infrastructure investments) is deemed increasingly vital to the European economy. We further argue that unlisted equities may in reality often represent a more correct value of the market – because they are less subject to the volatility – than that of listed markets – with the similar conclusion that applying to all these equities a punitive approach would be both disproportionate and unrelated to the real risk these pose.

These elements should not be seen as putting in question the relevance of determining prudent values of assets. We do not disagree that unlisted equities that are not subject to a specific evaluation process may well best fall under the fallback approach. Our point is rather than stopping at “observable market data” as a source of prudent valuation is a much too crude measure that does not do service to the diversity of EU capital markets and to the efforts taken beyond the listed world to properly value assets.

We also wish to alert the EBA that there is a considerable difference between “unlisted equities” and “investments in funds with a portfolio of unlisted equities” – and that this difference encompasses the risk of these assets. While the former is not necessarily subject to any specific requirements and do not benefit from any risk diversification benefits, the latter are subject to EU rules (under AIFMD) and are typically allowing the investor, in this case the bank, to benefit from a significant level of diversification.

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As a conclusion, we urge the EBA to adopt an approach sufficiently sophisticated for unlisted equities that have been subject to thorough and independent valuations to not be seen as less prudently valued than their listed counterparts. While we understand the creation of this methodology may be complex, it is from our perspective a necessary step the EBA should take to ensure banks can best asses the real value of their assets.

We remain of the view that the way the EBA will manage to apprehend the diversity of capital markets will be a crucial element in the success of the Capital Markets Union, considering the central role of banks in the European economy. As such, the EBA should not underestimate the negative impact of its approach on the EU achieving some of the objectives laid out in recent Eurogroup and European Council conclusions.

Below we are offering specific answer to the core question raised.

Question 5. Do you agree with the proposed amendments to the calibration of the fall-back approach? If you consider that a different range of percentages should be considered, or that the AVAs under the fall-back approach should be calculated in a different manner, please suggest a range or a methodology, as applicable, and provide a rationale and evidence supporting your proposal.

No. We fundamentally disagree with the proposed amendments to include any unlisted equities within the fallback approach, for the simple fact that their value cannot be corroborated with "observable market data".

In this specific case, we would argue that the EBA has not demonstrated that observable market data are necessarily more prudently valued than valuation methods of listed equities – and has therefore put itself in a position where it can only justify an imbalance between types of equities through a crude, and therefore likely in most cases inappropriate, assessment.

Such an imbalance can have wide ramifications on market practices, as the EBA's appreciation is taken on board by various market players. This could lead to higher charges to equities that were valued privately, irrespective of any levels of scrutiny these have been exposed to and the seriousness at which they have been examined. Most importantly, this could make it proportionally less interesting for banks to hold unlisted equities that have been prudently valued compared to any type of listed equity, irrespective of the underlying risks of respective assets.

In other words, the EBA approach is making a distinction so binary between public and private markets that it risks tilting credit institutions towards the former irrespective of the limited risk of the latter, with all the consequences it can have on the financing of EU businesses (also compared to non-EU businesses). Risk assessments should not be done on general categorisation of assets but on the realities of these assets.

Given the significance of falling under the fallback approach, we suggest that the EBA gives certain types of unlisted equities the opportunity - under specific conditions - to be subject to the same conditions as listed equities.

1. **"Observable market data" is only one relevant factor…which private markets learned to live without**

The overall argument of the EBA is that "it is difficult to ensure that the prudent values calculated for positions for which no quotes are available are appropriate, and that there is a level playing field

and institutions apply the RTS in a harmonised manner" because these "cannot be corroborated with any observable market data in many instances".

While such an approach may be considered prudent at first glance, it does show a strong bias towards the validity of public valuations which has not been demonstrated. To a large extent, listed market valuations are not at all done through an "accurate methodology" – they are simply the result of offer and demand – which can lead to wild down turns and excessive uptakes – which private markets are typically more sheltered from.

Public markets tend to overreact to information and their valuations can be persistently out of line with their fundamentals. In contrast, private market NAVs are arguably a valuable source of independent financial information, provided they are done under proper conditions.

This is particularly true of the valuations we are most familiar with: valuations of unlisted equities of businesses owned by venture capital, private equity, and infrastructure funds. As we will explain in this note, this type of unlisted equities is subject to a series of checks that ensure they are, although appraised differently from listed equities, valued in a way that determines a perfectly appropriate market value.

In general, there seems to be some confusion, which is exemplified by the way the EBA treated this point, about the nature of valuations of unlisted equities and how they correspond to their public market's equivalents.

While it is obvious that equities whose valuations have not been tested should be considered with caution, **it is a very narrow view to consider that "observable market data" is the only measure of relevance to determine whether a valuation is appropriate** (as opposed to private and fair expertise).

Data from 2019 to 2022 showed that when replicating the investment patterns of private market funds with listed indices, private equity backed businesses' NAVs are adjusted upwards and downwards in a similar fashion to listed indices[1].

Historically, private equity valuations have largely fitted with reality and have provided investors with the details they needed to make investments in the private sector – see for example this most recent detailed analysis.

The approach taken by the EBA will necessarily mean that unlisted equities valuations are by nature less correct, irrespective of the level of care at which these have been set by private experts, their level of acceptance by investors (which are the most concerned by these valuations) and general evidence established that these valuations were appropriate (i.e.: comparing valuations to the ultimate value of sales). It is worth pointing out that for unlisted equities within funds, valuations are systematically determined by fund managers and appraised independently by a third-party valuation officer on a quarterly basis (according to AIFMD). There is therefore already a legal basis to determine whether certain types of unlisted equities are valued correctly.

What private equity valuations are (and what they are not)

Private equity valuations are estimates of what the final value of the sale of a company will ultimately be based on professional assessments – while public equity valuations correspond to the collectively perceived economic value of a business based on a collective "feeling".

In a private equity context, when investors (including banks) commit to a fund, it is on a "cash-to-cash

[1] Private markets don't launder volatility, Financial Times opinion

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basis" – e.g. they are investing in a closed end fund, fully understanding that their returns will come over a period of time based on the distributions a fund makes, which themselves are ultimately driven by the realisation of the individual portfolio companies in the fund (at their fair value at point of sale – based on the consideration the buyer is prepared to pay at point of realisation). If investors need to sell their holding in a fund (which could be for a number of reasons) a secondary market should enable them to do this.

In that context it it is best to properly analyse the risk of valuations in a private equity context, not to compare private and public market valuations as if they were directly comparable but instead to look at specific features of private equity valuations to see where they might diverge from realities of investments (as opposed to realities of public markets)[2].

Public share price valuations (in terms of share prices referred to as being valued "many times a minute") are not like-for-like comparable to private equity valuations. The public price at any given minute is influenced by several external factors other than a company's performance – buying and selling volumes, short selling strategies, directors buying and selling, global news, macro shocks and surprises, government policy (e.g., quantitative easing) etc. There can be significant volatility. Irrational exuberance can indeed determine part of the price. Minute by minute public share price valuations are also only valuing what is a small minority stake in a business. Public valuations are at best looking in from afar, as they do not necessarily have as regular access to the companies' performance or take decisions without having looked at such information.

2. There are methods to determine the soundness of a private valuation

The soundness of unlisted equities, and in our case private equity owned businesses valuations (valuations handled by the managers), will be the result of a series of elements:

1) They are prepared professionally and based on **well-developed industry standards.**

In the private equity case, the International Private Equity and Venture Capital Valuation (IPEV) Guidelines are principles-based, market segment-specific and recognised as the industry standard for valuing PE/VC-backed portfolio companies. The IPEV guidelines ensure robustness, quality, and consistency in valuation methods across the industry, for the benefit of investors. Managers also typically follow international accounting standards.

2) They are **independently audited.**

[2] Notably, "industries where private equity funds invest […] appear less exposed to aggregate shocks" (Bernstein, S., Lerner, J., Sorensen, M., Strömberg, P., Private Equity and Industry Performance, 2022). Fund managers are better at handling these shocks, as "PE-backed firms restructure more quickly and more often out of court and are less likely to be liquidated. PE owners are more likely to retain control post-restructuring than other pre-default owners, often by infusing capital as firms approach distress." (Hotchkiss, E., Strömberg, P., Smith, D., Private Equity and the Resolution of Financial Distress, 2021).

On the notion of risk in private equity, "*during the 2008 crisis, PE-backed companies decreased investments less than did their peers and experienced greater equity and debt inflows, higher asset growth, and increased market share. These effects are especially strong among financially constrained companies and those whose PE investors had more resources at the crisis onset. In a survey, PE firms report being active investors during the crisis and spending more time working with their portfolio companies*." (Bernstein, S., Lerner, J., Mezzanotti, F., Private Equity and Financial Fragility during the Crisis, 2018).

In the private equity case, managers of EU funds with more than €500m of assets under management are subject to regulatory requirements relating to valuations, which require internal valuations to be functionally and hierarchically separate from investment functions.

3) There are **sufficient incentives** for owners to present appropriate valuations.

In the private equity case, managers have no interest in proposing wrong valuations as their businesses and career depend on them raising further, "successor" funds every few years, the foundation of which will usually be repeat commitments from investors in the previous fund. This creates business-critical investor relations and fundraising incentives for managers to ensure that their investors receive robust valuation information.

4) Investors themselves are involved in setting the valuations.

In the private equity case, the expertise and the close, long-term relationships inherent in illiquid investments allow institutional investors to observe, scrutinise and hold to account a manager's approach to valuations over time. For example, an inflated final, pre-sale valuation would be rudely exposed if the actual exit price achieved were significantly lower.

It is worth flagging that this commercial dynamic, is more likely to depress valuations rather than inflate them (studies indeed suggest that realised exit prices have typically been higher than the previous, pre-sale "fair value" valuation estimated).

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As can be seen, there are **extensive mechanisms to ensure their valuations are correct** for equity investments when done via a venture capital, private equity, or infrastructure fund. This is obviously of key relevance for these markets to function correctly.

Not taking these factors into account in the EBA standards is noticeably problematic as it denies the way part of the EU capital markets has dealt with uncertainty – with all the consequences it can have for our Union to develop these markets.

But, and perhaps most importantly from the perspective of the EBA, it also means that, by not including these mechanisms in its thinking, it would create a set of rules that does not appropriately represent the real risk of exposures, **making the CRR regime less fit for purpose and less agile than it should be**.

While it could be tempting to consider that an overly prudent approach to some assets may not have consequences, it is hardly unknown that the general lack of ability of banks to finance the economy, by investing indirectly, in unlisted businesses is ultimately weighing on these businesses, on the EU's industrial development and ultimately on the overall soundness of the EU financial system.

At a time where private financing is needed to finance the EU transition towards a more sustainable and resilient economy, measures such as this one that would drive banks – or EU financial institutions overall - away from private assets are not to be taken lightly, especially if their prudential value is undetermined.

In conclusion: Imposing the fallback approach to all unlisted equity valuations would in reality be a punitive regime, based on a too narrow interpretation of what constitutes an appropriate mechanism to assess price.

We would therefore call for the EBA profoundly reconsider its position and take the circumstances in which unlisted equity valuations have been tested, for example through a series of criteria mirroring the ones we have laid out above, into account.

We understand this would make the existing regime slightly more complex. Nonetheless, it would be an important step towards the logical recognition of the diversity of funding mechanisms within the European Union – and would significantly improve the CRR model.

We are evidently at the EBA disposal to assist in this endeavour.