bvca The voice of long-term investment

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Dear Sonia

FSA Quarterly Consultation – Prudential treatment of venture capital investments

The British Venture Capital and Private Equity Association ("BVCA") represents the overwhelming majority of UK-based private equity and venture capital firms.

I am writing to express industry anxiety about the investment implications of the above. Whilst we welcome the new investment that the Business Growth Fund will likely bring and recognise the need to find suitable prudential treatment, the implications of any proposed rule changes for the ability of other private equity and venture capital investors to continue to secure bank investment need careful monitoring. We estimate that banks currently make up 7% of the total investments in independent UK private equity and venture capital funds. This is an important source of funding for small and medium sized businesses.

We would very much like to meet with you to discuss the proposed rule changes and the FSA's general policy in this area, in particular to cover the points set out below.

Firstly we understand that the starting point for the regulatory capital treatment of private equity and venture capital investments by firms subject to the Banking Consolidation Directive is that they should be risk weighted. It has been our understanding that the Directive allows for risk weighting of 190% or 370% under the simple risk weight approach, amounting to a 15% or 30% holding of capital against the investment. We would like to understand from you whether the FSA's broad policy approach is to follow the BCD in this regard in relation to private equity and venture capital investments in general. We are not aware of any prior public consultation indicating that the FSA takes a different policy approach to the BCD on this matter.

Secondly, we would like to discuss with you the ambit of the proposed carve out from the material holdings rules based on the definition of "financial institution". We understand that bank investment outside the financial sector is addressed in BCD through the concept of qualifying holdings. We agree that the purpose of "material holdings" is to avoid double counting of capital in the financial sector. Having regard to the purpose for which "financial institution" is used in BCD, we understand that term does not include holding companies which invest principally outside the financial sector.

We would like to understand better whether the FSA shares this interpretation, as this was not clear to us from the CP. We are concerned that a contrary interpretation would give rise to unexpected and unwelcome consequences, including potentially undermining the efficacy of the proposed rule changes set out in the CP.

Thirdly, we note that well diversified funds often invest in businesses which have some involvement in providing financial services as an ancillary part of their main activity, or which provide financial services as a core part of their activity but are not required to hold regulatory capital. We would like to understand the FSA's approach to the regulatory capital treatment of investments in venture capital and private equity funds investing in these businesses.

Fourth, we understand that the default FSA rules require banks to deduct from regulatory capital participations and subsidiary holdings which are not included within the scope of consolidation, a position which we understand is super-equivalent to the BCD. For the reasons given in paragraph 5.7 of the consultation paper in relation to material holdings, we do not consider that this is an appropriate default approach in relation to venture capital investments, particularly in light of the risk weighting approach set out in the BCD. The effect of a deduction is akin to writing off the entire value of the investment. Indeed if the investment is successful so that the value of the initial investment grows, the deduction increases prior to a sale. That acts as a potentially significant disincentive from investing in small companies (where a small investment may give rise to a large holding in percentage ownership terms, thus triggering a deduction) when compared with investment in large companies (where a larger investment can give rise to a smaller holding in percentage terms, thus triggering a risk weighting).

Lastly with respect to risk-weighting, the proposed definition of 'sufficiently diversified' in the CP might apply in practice to the Business Growth Fund but will not apply to the vast majority of venture capital and private equity funds. Typical funds will not make 30 investments nor have a maximum of 20% in one single sector. We are concerned that this approach will create an unlevel playing field between funds.

Without practicable exemptions, we are concerned that the requirements around deduction of material holdings, participations and subsidiaries could result in an effective risk weighting of 1250% and would lead to banks re-evaluating their future investment activity in private equity and venture capital. In a worse-case scenario there may even be a fire sale of current holdings. We are also concerned that the proposed definition of "sufficiently diversified" would mean the only fund meeting this requirement would be the British Growth Fund. Based on an appraisal of BVCA membership we estimate this could impact on up to 30% of all member funds (including captive, semi-captive and independent funds) – a significant proportion. This could lead to a curtailment of investment in small and medium sized enterprises at the worst possible time for the UK economy.

We will respond formally to the consultation but in the mean time a prior discussion between industry and the FSA is essential if a viable solution is to be found. We welcome the new equity capital that the Business Growth Fund will bring but it would be counterproductive if it came at the expense of investment elsewhere in the industry.

If you are amenable to a meeting please could you contact my colleague Simon Horner (shorner@bvca.co.uk) at the BVCA to arrange.

Yours sincerely,

Mark Florman
Chief Executive
BVCA-The British Private Equity & Venture Capital Association