HM Treasury

By email: SolvencyIIReview@hmtreasury.gov.uk

19 February 2021

Dear Sir, Madam

Re: BVCA response to HM Treasury Review of Solvency II: Call for Evidence (the "Review Paper")

We are writing on behalf of the British Private Equity and Venture Capital Association (BVCA), the industry body and public policy advocate for the venture capital and private equity industry in the UK. With a membership of over 700 firms, we represent the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers and investors. Between 2015 and 2019, BVCA members invested over £43bn into nearly 3,230 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private equity and venture capital currently employ 972,000 people in the UK and the majority of the businesses our members invest in are small and medium-sized businesses.

We also speak on behalf of institutional investors, including pension funds and insurers, which are committing capital to the funds these firms have set up. As such, we take a great interest in the impact any changes to the prudential regulatory regime for the insurance sector (in particular any changes to the how an insurer calculates its solvency capital ratio (SCR)) could have on investment by insurance companies in venture capital and growth funds.

The risk weights applied under the SCR requirements have a major influence on the insurers' ability to support, among others, start-ups through venture capital funds, scale-ups through growth capital funds or large-scale infrastructure projects through infrastructure funds. Indeed, as the capital requirements introduced under Solvency II made equity investments less attractive, it became part of a general trend that forced insurers to withdraw from this asset class as a whole and disproportionately affected some types of long-term equities.

An appropriate balance should be found between ensuring the safety and soundness of insurance firms and ensuring that insurers as long-term investors can remain able to supply capital to long-term projects. We feel that an appropriate tailored risk-weight can be introduced for exposures such as venture and growth capital, which protects insurers from having to apply an inappropriate risk volatility assessment (which is relevant to the SCR calculation under bother the standardised approach and an internal model) and which reflects the specific characteristics of venture capital and growth funds.

We therefore welcome the opportunity to respond to the Review Paper.

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Overall comments and key points

As we noted above, signs indicate that the Solvency II framework has incentivised insurers to retrench from more long-term and thus illiquid assets. Over the past few years, insurers' investment in equities have been reduced by half, from 20% to 10% of their total assets[1]. As Solvency II capital requirements made equity investments less attractive, it became part of a general trend that forced insurers to withdraw from this asset class as a whole and disproportionately affected some types of long-term equities[2].

The EU's amendment to Solvency II to introduce the Long-term Equity (LTE) category of equity investments only partially addressed this issue. The LTE category complements the one-year VaR view underpinning Solvency II with a long-term investment view (and so in this way recognising the role of insurers as long-term investors). The LTE category essentially "shelters", under certain conditions, illiquid assets (such as investments in venture or growth capital) from an inappropriate volatility assessment (a volatility assessment being at the core of the SCR equity risk module), so taking into account to some extent the specific characteristics of those assets.

In our opinion, it is possible to further to tailor the criteria for portfolios to fall within a dedicated "long-term" category, which is the best route to increase the ability of insurers to support equity exposures to venture and growth funds. In particular, de-coupling the assessment of the risk of such illiquid, long-term equity exposures from a comparison to listed equities held for the long-term, that does not take into account the way insurers structure their long-term portfolios and the specific characteristics of holding such illiquid exposures.

For example, the methodologies for the SCR could give more scope for insurers to take into account the diversification of their portfolios. We feel that diversification of an exposure within an asset class (rather than simply diversification in different asset classes or types of equities) has not to date been appropriately measured within the Solvency II framework. BVCA (and Invest Europe) studies show that the risk of losing any capital over the entire holding period with a portfolio of just 15 funds is far lower than, for example, the reduced 22% capital charge applying to LTE investments and that a portfolio can essentially be risk free when it contains 25 or more funds[3].

Similarly, the approach of requiring insurers to take into account volatility of investments in venture or growth capital does not reflect that insurers do not typically sell such interests before the end of the life of a fund. For example, when an insurer makes a commitment to a closed-ended private equity fund, it does so for a fixed ten-year period (often extended by two further years or more)[4]. It would be more appropriate to give scope to recognise realisation risk – i.e. the risk that an insurer will lose its capital at the end of its investment. Realisation risk is linked to the long-term performance of the fund (and ultimately the success of the underlying businesses and of the patient capital approach).

In our view, further tailoring the criteria for investments within a "long-term" category, such as venture and growth, would be valid for insurers whether they are on the standardised model or the

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[1] Paris Market Place Report "Betting on the Long-Term".

[2] According to EIOPA, only 0.6% of insurers' investments are made in private equity funds (EIOPA European Insurance Overview, 2018).

[3] Likewise, if it is assumed in the calculation of risk weightings that listed equity portfolios are diversified across industries and sectors, then the very significant impact on risk of diversification across funds by stage, manager, geography, year of investment should be considered.

[4] And s a minimum, insurers will want to hold until the investment period of the relevant fund ends, to ensure that there has been time for the fund manager to deploy the capital and appropriately realise investments.

internal model. The way in which risk weightings are computed under the standard formula also have a huge impact on internal model's insurers' calculations. One has to take into consideration that, usually, a private equity portfolio represents only a small fraction of the total assets under management by insurance companies. This means that, for them, investing resources in calculating ex-novo an appropriate risk weight for a private equity portfolio is uneconomic. As a consequence, they may rely on the risk weightings proposed under the standard formula and incorporate them in their internal model, maybe with some adjustments (usually even more conservative).

We also noted that the Review Paper raises the possibility of amendments to improve the current mobilisation regime for new insurance firms. From our understanding of the market, we would see any such changes as a positive step, particularly for insurtechs (who currently realistically have to partner with incumbent insurers as the costs and compliance burden of becoming a standalone insurer are prohibitive).

Responses to consultation questions

We have responded to the questions in the consultation most relevant to PE/VC funds.

Q15. What changes, if any, could be made to the methodologies that insurance firms can use to calculate the SCR, including by removal of potential barriers, to enable them to provide long-term capital to support growth, including to invest in infrastructure, venture capital and growth equity, and other long term productive assets, consistent with the Government's objectives?

As we set out above, in our view the SCR requirements under Solvency II made long-term illiquid equities less attractive for insurers (in particular, insurers unable to use the internal model). We are of the view that insurers' investments in private equity and venture funds are a good example of the nature of long-term commitments these investors can make, and that there should be more scope under the SCR to take into account the specific characteristics of long-term investments such as venture and growth capital. As recognised in many reports, and in particular the "Betting on the longterm report" prepared by the Paris Marketplace, approaches to date under Solvency II have overestimated the risk of long-term equities. Given this, we feel that the SCR methodologies can be revised to more appropriately reflect the characteristics of venture and growth capital investments without affecting the prudential soundness of insurers.

We would be happy to discuss the contents of this letter with you; please contact Tom Taylor (ttaylor@bvca.co.uk).

Yours faithfully,

Tim Lewis
Chair, BVCA Regulatory Committee