ISSN: 2688-9323

Discussion on the Existing Risks of Private Equity Funds and How to Solve it

Xin Ding*, Xin Kuang, Jiayan Zhong, Su Li, Xianyue Pan

Shandong University of Science and Technology, Jinan, Shandong, 250031, China

*945747395@qq.com

Abstract

In the context of the rapid development of modern social economy, a variety of different types of financial products have emerged in the field of financial market. As a very mainstream securities investment, private equity has made a certain contribution to promote the prosperity and development of the financial industry. This paper expounds the basic concept and characteristics of private equity, and points out the necessity and significance of developing private equity actively. This paper analyzes the risks it faces in market environment, credit management, compliance with laws and regulations, and operation execution. We discuss the main causes of private equity risk events. From the perspectives of supervision department, custodian institution, outsourcing institution, fund manager and investors, the risk prevention and solution strategies of private equity fund are discussed. It also puts forward some suggestions on the development of private equity industry. We hope this article can provide reference for relevant people and institutions.

Keywords

Private Equity Funds; Risk; Supervision; Investment.

1. Introduction

With the rapid development of modern society, the financial industry is in a state of diversified development. The continuous accumulation of residents' wealth has prompted the continuous emergence of various financial products. As a relatively mainstream financial product at present, private equity funds have become the object of investment and financial management for many residents. However, due to the low threshold for private equity institutions and the difficulty of product supervision, private equity fund risk events frequently occur. This not only leads to losses for investors, but also adversely affects the prosperity and stability of financial markets. Since 2018, problems such as business interruption and payment crisis of private equity funds in various regions have emerged one after another, and some cases have involved billions of dollars in funds. It is worth noting that the private equity fund institutions in some cases have completed the grade filing in strict accordance with the regulations, and the products are also managed by banks, but risk events still occur. This also shows that there is still a long way to go for the risk management and risk prevention of private equity funds in my country.

2. Overview of Private Equity Funds

2.1. Concept

A private equity fund is an investment fund that raises funds in a non-public way and raises funds from special investors with special goals. Among them, the word "private equity" means that it is not open to the general public and has not raised public funds. Compared with public funds, it has obvious differences in the richness of financing channels. Private equity fund property investment projects include options, bonds, equity, fund shares, etc. The main types include asset allocation, securities investment, etc. The confirmation procedures for specific targets of private equity funds include: first, the fundraising agency shall use questionnaires and other methods to evaluate the target investors' ability to resist risks and identify risks, and inform investment risks in accordance with relevant regulations. Second, the investor makes a written commitment to the investor's standards and qualifications, and submits it to the fundraising agency [1]. In addition, the evaluation results of private equity fund investors are valid within three years. If the fundraising agency continues to promote the fund after the expiration, it needs to re-assess the risk of the project. In private fund management, the definition of qualified investors among investors is a very critical link. Qualified investors refer to private equity fund investors with good risk identification and anti-risk capabilities.

2.2. Characteristic

As a type of financial investment product, private equity funds mainly have the following characteristics.

First, the requirements for information disclosure are not high. In the process of preparation, promotion and management of private equity funds, information on its corresponding links or investment objects is generally not disclosed. Only according to the terms of the contract and the agreed content, the fund operation situation is reported to investors on a regular basis. Generally speaking, the confidentiality of private equity funds is relatively strong [2].

Second, the scope of fund-raising targets is narrow. As mentioned above, private equity funds use a non-public method to raise funds, and only raise and issue funds to qualified individual investors or institutions, and are not open to the public for sale.

Third, the fund-raising and management units have relatively strong income stability. From the perspective of the issuance and management income of private funds, not only a certain proportion of management fees need to be charged according to the size of the fund, but also the share enjoyed according to the performance return. In other words, private equity fund institutions are relatively stable and transparent in terms of capital income.

Fourth, asset management flexibility is relatively strong. From the perspective of the basic characteristics of private equity funds, due to the relatively small scope of investors, in terms of fund issuance and management, investment strategies can usually be customized according to investors' risk preferences. At the same time, fund managers can flexibly deal with investment goals and directions according to the actual situation of investors and their own risk analysis. Of course, there is flexibility in the reward distribution strategy associated with it.

3. The Necessity and Significance of Promoting the Development of Private Equity Funds

Private equity funds are the product of social and economic development and the continuous evolution of the financial industry, which is also a supplement to my country's current financial product system. Judging from the experience of foreign economic development and the development trend of the domestic financial industry, the necessity of encouraging and effectively promoting the development of private equity funds is mainly reflected in the following aspects.

3.1. Provide a Good Investment Direction for the Growth of Residents' Wealth and the Improvement of Economic Level

Since the reform and opening up, my country's social economy has developed rapidly, and residents' wealth has grown in an all-round way. On the basis of food and clothing, residents have more surplus wealth. The issuance of private equity funds means that residents have a relatively low threshold and more flexible investment channel, and can use the endowed wealth to create income and promote the further growth of wealth [3]. At the same time, under this background, high-net-worth investors are no longer satisfied with the low yield of public funds, but turn their attention to private funds, which directly promotes the expansion of the scale of private funds in my country. As of the end of 2020, the paid-in scale of my country's private funds exceeded 15 trillion yuan, which once surpassed the total assets of public funds. From the perspective of asset management, the compensation mechanism of the private equity fund industry has become market-oriented, and a large number of excellent fund managers have turned to the private equity fund industry to become fund managers. Obviously, the influx of talents has also made outstanding contributions to private fund investment research, information release, and issuance management. In recent years, the performance of private equity funds has grown significantly, and the investment returns of investors have also risen.

3.2. Contribute to the Innovative Development of the Real Economy

At present, in the field of private equity funds in my country, a considerable number of funds invest in innovative technology industries, which have made key contributions to the development of the current social real economy. From the point of view of the operation and development of technological innovation enterprises, such enterprises generally have the characteristics of less assets and weaker anti-risk ability, and because of the certain pioneering and innovative nature of this industry, it is difficult to obtain bank credit funds in some cases. support [4]. With sufficient flexibility and rich experience in risk control, private equity funds can screen small and medium-sized technological innovations and select investment targets with great potential. This will not only help alleviate the financing difficulties of small and medium-sized scientific and technological innovation enterprises, but also promote the overall development of the real economy of the whole society. For example, private equity investment funds, as a main form of private equity funds, can invest in small and medium-sized enterprises in the middle and late stages of their entrepreneurship to help them achieve further development.

4. Analysis of the Existing Main Risks of Private Equity Funds

4.1. Market Environment Risk

Any financial investment product in the financial market will be affected by the market environment during the issuance and management process. The linkage of the financial market means that private equity investment will inevitably face external risks, and market environment risks are the main content of external risks. In recent years, my country's social and economic development has entered a new normal. On the one hand, in the context of economic globalization, the state of global economic development will have an impact on the stability of the domestic financial market; on the other hand, the diversified development of social industries and the prosperity of private equity funds have also intensified the competition among related investment companies to a certain extent. . In the fierce competition, private fund projects will inevitably be affected by various market factors. Obviously, a good external market environment can give private funds a good space for development, while the volatile market conditions will affect the development of private funds.

ISSN: 2688-9323

4.2. Credit Risk

Like all financial products, credit management is the core part of the issuance management of private equity funds. The reliability of the credit of each participant is the basic premise for the development of private equity funds to achieve a win-win situation for all parties. However, some problems have also been exposed in the comprehensive development of my country's private equity funds, leading to the emergence of credit risks. For example, the information disclosure mechanism of private funds is not perfect, and the information mismatch in the process of fund raising and issuance management is the main reason for credit risk. For another example, as a fund manager plays a central role in the issuance and management of private equity funds, in addition to mastering good professional skills, it also needs to have good professional quality and strictly abide by relevant regulations [5]. However, if the fund manager defaults and violates regulations, the resulting credit risk will directly lead to losses for investors, which will also have a devastating impact on the issuance of the fund. From another point of view, based on the principal-agent theory, the pursuit of corporate profits is one of the main goals of the agent. But at the same time, it also hopes to maximize its own interests, so in actual operation and management, there may be deviations from the expectations of the owner of the enterprise. From the perspective of the relevant laws and regulations of private equity funds, personal assets reaching 1 million is the main requirement for qualified investors of private equity funds. However, in many cases, investors do not understand fund investment projects, which also exposes the problem of information symmetry and leads to increased credit risk. Finally, the private equity fund contracts signed in the issuance and management of private equity funds may have deficiencies in legal protection, which will also lead to credit risks.

4.3. Legal Risk

In the context of the sustainable development of my country's social economy, the corresponding laws and regulations are constantly being improved, but this requires a certain amount of time and process. The law of social development shows that the issuance and management of financial products in various periods is bound to face certain legal risks. First of all, because the fund manager does not have a deep understanding of the legal provisions, it is likely to lead to illegal acts in the fund-raising process that it guides and executes, which will directly lead to increased legal risks. Secondly, in the process of formulating laws and regulations, the state usually considers the status quo and trends of social and economic development, and also needs to play the role of macro-control, which means that the promulgation of some laws and regulations will directly affect the issuance management of some traditional private equity fund projects. Influence. In 2014, the promulgation of the "Interim Measures for the Supervision and Administration of Private Investment Funds" means that the legal status of private equity funds has been recognized. Since then, private equity funds have ushered in an explosive development trend. However, the current operation of private equity funds has not been effectively regulated throughout the entire process, and some links still have problems of lack of supervision. From the point of view of the issuance management process of private funds, only a privately signed contract between fund managers and investors represents their principal-agent relationship, but this relationship is not fully protected by law. The imperfection of the regulatory system and mechanism means that some private equity fund units may not explain risk information to investors in order to obtain a large amount of funds faster or to pursue interests, and even resort to deceitful methods to sign contracts with investors.

4.4. Issuance Management and Operational Risk

In the issuance management and operation of private funds, fundraising units or fund managers will adopt some high-risk methods for certain purposes, which will lead to risks for fund projects and investors. For example, in the current field of private equity funds, leveraged operations exist from time to time, and insider trading behaviors further aggravate risks. Because private equity funds are highly leveraged, some institutions do not hesitate to use extremely high leverage to borrow several times or even dozens of times of investment funds, which directly leads to uncontrollable risks. And if it fails, it will have extremely serious consequences. Of course, in the issuance and management of private funds, the professional ability and quality of fund managers have an important impact. If the manager's professional foundation is not solid, the experience is insufficient, the risk management ability is poor, and the sense of responsibility is insufficient, it may cause the project and the investors to face risks.

5. Prevention and Treatment of Private Equity Fund Risks

5.1. Market Analysis and Evaluation Work Needs to be Taken Seriously

In any case, comprehensive analysis of the market environment should be carried out with regard to the preparation of a private equity fund project. Fully combine the stability of the financial market, the development status of the target industry, and the policy environment to analyze the external market environment of the fund project. In this process, the design and innovation of hedging financial instruments is a very effective method. For example, in the hedging operations of financial instruments such as futures options and swap transactions, American hedge funds diversify the market risks of fund projects through diversified investment portfolios. Therefore, in addition to market analysis and evaluation, my country's private equity fund units should also actively use innovative hedging financial tools to reduce the impact of market risks.

5.2. Establish a Good Information Disclosure Mechanism and Strengthen Project Supervision

Regarding the prevention of credit risks, private equity fund units should take the initiative to take responsibility and establish a good information disclosure mechanism. When conducting investor recruitment and cooperative management, fund units should disclose project information well, and conduct a comprehensive review and assessment of investors' risk identification and anti-risk capabilities. In the process of project advancement, strengthen the communication between fund managers and investors, and conduct information disclosure in strict accordance with the requirements. In addition, strengthening the supervision of fund managers is essential. Regular performance appraisal should be carried out to urge managers to continuously improve their personal professional ability and professionalism, so as to lay a reliable foundation for the orderly advancement of the project [6].

5.3. Further Improve Laws and Regulations and Improve the Overall Quality of Investors

Regarding the prevention and control of legal and regulatory risks: on the one hand, it is necessary to insist on improving the laws, regulations, systems and standards in the field of private equity funds to establish a good legal foundation for the development of this field; on the other hand, it is necessary to strengthen legal education to ensure that private equity funds The project parties, fund managers, fundraising units and investors have sufficient understanding of the laws and regulations. From the perspective of investors, relevant state management departments, private equity fund raisers, fund managers, etc. should take the initiative to take responsibility. Do a good job in investor education through various channels, improve investor literacy, and reduce blind investment.

ISSN: 2688-9323

5.4. Improve the Internal Operation Mode and Establish Management Standards

For the fund raising, issuance management, project promotion and other work of private fund projects, it is necessary to insist on improving and perfecting the internal operation mode to avoid operational management risks. For example, foreign experience can be used to encourage the adoption of a limited partnership system, and responsibilities can be clearly divided through the cooperative management of general partners and limited partners. On this basis, relevant departments should strengthen supervision and guidance, avoid unlimited leveraged lending, and control operational management risks within a reasonable range.

6. Conclusion

In summary. With the rapid development of modern society and economy, the financial market also presents a trend of diversified development. As an important financial product and investment type, private equity funds have attracted much attention. However, due to the influence of traditional concepts, market environment and institutional environment, the credit risks, environmental risks, operational management risks and legal risks faced by private equity funds in my country should not be underestimated. This requires the joint efforts of management departments, private equity fund units, fund managers and even investors. We should continuously improve the corresponding management and operation mechanism, effectively avoid various risks in the management of private equity issuance, and make key contributions to the prosperity and development of the financial market.

References

[1] Ma Xin. Analysis of the Risks and Countermeasures of Fund Management in Private Equity Investment Funds [J]. China Collective Economy, 2021(6):107-109.

[2] Han Jiajing. Risk Management Based on Private Equity Fund Investment [J]. SME Management and Technology, 2021(26):71-73.

[3] Zeng Xi. Risks of Private Equity Investment Funds and Risk Control Countermeasures in Financial Management [J]. Finance, 2021(9):60-61.

[4] Yang Cuicui. Analysis of financial management risk prevention and control strategies in the process of enterprise operation [J]. Quality, 2021(19):10.

[5] Zhang Yi. Research on Risk Management and Control of Private Private Equity Investment Fund Companies - Taking A Equity Investment Management Co., Ltd. as an example [D]. Harbin University of Commerce, 2020.

[6] Yan Yan. Reconsideration of "Release" and "Management" of Private Equity Fund Managers' Market Access in my country [J]. Financial Theory and Practice, 2021(5):88-95.