Channel Islands
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On behalf of the governments and financial services regulators of the Channel Islands of Guernsey and Jersey

Response to the European Commission Call for Evidence:

EU Regulatory Framework for financial services

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About the Channel Islands

The Channel Islands ('the Islands') consist of the Bailiwicks of Guernsey and Jersey. They are British Crown Dependencies. They are not part of the United Kingdom, but the UK has ultimate responsibility for their external affairs and defence. The Islands enjoy a high degree of autonomy, including their own fiscal and judicial systems, and receive no financial subsidy from the UK or the EU. By virtue of Protocol 3 of the UK's Accession Treaty, the Islands are part of the Customs Union and within the Single Market for the purposes of trade in goods, but not services and as such are treated as "third countries" in financial services regulation. The Islands are part of the Sterling Zone and by virtue of equivalence under the EU's Wire Transfer Regulation are part of the UK's payment and clearing system.

The OECD Convention was extended to Guernsey and Jersey in 1990 and they are part of the UK for the purposes of its membership of the OECD. OECD Decisions and Recommendations apply to Guernsey and Jersey to the same extent as they do to the UK unless the contrary is specifically stated in a particular case – further details can be found on the OECD's website.

About Channel Islands Brussels Office

The Channel Islands Brussels Office (CIBO) was established in 2011 as the joint office of the Governments of Guernsey and Jersey to promote and protect the interests of the Channel Islands in Europe. CIBO has three permanent staff, employed under Belgian employment law. Its legal status is as a Belgian not-for-profit association (fondation privée). It is accountable to, and governed by, a Board of Directors (two Directors from each Bailiwick). It takes political direction from Ministers.

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Opening remarks

The Channel Islands are home to a significant and sizable finance sector whose success is founded on professionalism, regulatory leadership and a commitment to meeting international standards and co-operation. The Channel Islands funds sector's particular expertise is in the closed ended alternative funds sector and in the marketing to professional investors.

We believe we have a valuable perspective as third country jurisdictions to provide to the European Commission, to assist it achieve success in its objective of creating a true Capital Markets Union in the EU, supporting jobs and growth across Europe

The Channel Islands have a demonstrable track record in the application of equivalent regulatory approaches to the European Union where there is a relevant contribution by the Channel Islands to the EU markets. In the summer of 2015 ESMA's public opinion was that both Islands' funds regimes were effectively equivalent under AIFMD and that there were no grounds not to extend the passport to the islands.

Both Islands were pleased to respond to the European Commission's general consultation on Capital Markets Union in early 2015 and in this spirit we stand ready to provide whatever further contribution to this work the European Commission might find helpful, including attending workshops and meetings and contributing additional materials in writing.

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Summary

We have focused our response on areas where we are providing comments based on our specific expertise and experience to support the objectives of CMU, primarily in relation to the area of most mutual interest and potential mutual benefit – the funds sector. We have not commented on issues of intra-EU competence.

The overall message supported by our evidence is that it is in the clear interests of the EU (and the CMU project) to open up EU markets to international managers and investors and remove internal regulatory barriers.

To reiterate the points made in our general CMU responses in early 2015, having the broadest possible range of managers and marketers can only serve to increase the numbers and types of funds and investments. When third country managers are supervised according to equivalent proportionate regulatory standards there is no justification for their exclusion. Indeed, any such exclusion undermines the interests of the EU, working against the objectives of CMU as it mitigates against providing access of EU investors to global capital markets and global investments – access that is vital to the EU growth and jobs agenda.

We have, where possible, given explicit examples and significantly we have attempted to quantify the benefits of our suggestions.

The following examples are illustrative, based on our own estimates of the counterfactual scenario in each instance. They are provided to give an informed estimate of the scale of the benefits that we believe would accompany an opening up of EU capital markets to global capital flows through the removal of unwarranted regulatory barriers:

- Based on the current scope, if third country managers had been permitted to participate in the **EuVECA** regime from launch, a further €600m of investment funds (or 50%) could have been made available through passport to early stage and start-up European companies.[1]
- Opening up **ELTIFs** to third country managers could create an additional envelope available for investment into European infrastructure assets through ELTIFS routed via Channel Islands to be €10-€20bn per annum (a marginal increase of 33% of institutional (over and above the EIB's optimistic scenario estimates) investment in European infrastructure assets).
- A removal of all additional fees and administrative barriers outside the host or Member State of reference for authorised **AIFs** together with an immediate extension of the AIFMD passport to third country jurisdictions passing ESMA assessments could result in an additional further €12.5-€25bn global capital flows into EU investments.

[1] These are our estimates that have been calculated utilising the data from ESMA's advice to the European Parliament concerning the application of the AIFMD passport to non-EU AIFMs and AIFs, and employing the methodology as described in this submission.

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Rules affecting the ability of the economy to finance itself and grow

Issue 1 – Unnecessary regulatory constraints on financing

1. *To which Directive and/or Regulation do you refer to in your example?*

Regulation (EU) 2015/760 – European long-term investment funds

2. *Please provide an executive/succinct summary of your example*

The Regulation precludes non EU AIFMs and AIFs from participation in the ELTIF regime.

This exclusion is inconsistent with the objectives of CMU – to reduce the impediments to free flow of capital internationally and to increase market based financing of investment.

The current approach of the ELTIF Regulation implies that international investment in European infrastructure assets is welcome only so long as the investment is routed through funds managed and domiciled in the EU but that international investment in European infrastructure assets is unwelcome if it flows through funds or managers based outside the EU. This in our opinion is counterproductive, harmful to the European economy and its citizens, and contrary to the objectives of CMU.

As we stated in our general CMU responses in early 2015, and consistent with our separate response to the EuVECA consultation, having a diversified and broad source of potential funds and managers can only serve to increase ELTIF numbers and investment in EU infrastructure routed through them.

An understanding of behavioural economics help explain how investors can be parochial, and barriers have traditionally prevented much cross border investment in the EU. ELTIF is a product designed to address the barriers and encourage a new set of investment behaviours. Investment managers based in international financial centres such as the Channel Islands have extensive experience of working cross border. Therefore their experience of sourcing investment for EU infrastructure asset investment from outside of the EU should be encouraged, and will benefit the EU, supporting the objectives of CMU.

Removing such barriers will also enable and ultimately encourage international investors to invest through third country funds and will specifically support the ELTIF market, as well as the overall objective of CMU.

3. *Provide supporting relevant, verifiable empirical evidence*

The European Commission's own estimate is for existing infrastructure transaction volumes at €100-€150 billion a year. It also estimates that €1.5 to €2 trillion will be needed to finance infrastructure project needs in the EU up to 2020.

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European Investment Bank research[2] states that 'an increase of average asset allocation of up to 3% or 5% across the board (from current levels) over the next ten years' (by institutional investors) would only imply an additional annual capital supply in Europe of €30-€50bn contribution to infrastructure finance from institutional investors. It states a 'strong shift' in asset allocations is required to achieve this and that in any event this is no more than 10% of projected infrastructure investment requirements. It states 'such amounts are perhaps short of the high expectations often raised'.

Given the scale of the required investments it seems counterintuitive not to be open to the funding that non–EU AIFMs have the potential to provide. The Channel Islands themselves is at present home to €500bn of funds. Its specialism is closed ended alternative investments, primarily real estate and private equity, with a strong weighting in infrastructure assets, around 40% private equity overall and 20% infrastructure.

Underlying growth rates experienced during the period 2004 - 2008 were in the region of 30-40%, correlating near perfectly with global industry pre-investment cash reserve ("dry powder") growth rates over the period reported by Prequin[3]. Prequin reports current dry powder growth rates to be around 10-15% with similar projections of growth in the near term. At such levels this implies a potential projected envelope available for investment into European infrastructure assets through ELTIFs routed via Channel Islands to be €10-€20bn per annum. Alternatively this would equate to a marginal increase of 33% of institutional investment in European infrastructure assets over and above the 'optimistic scenario' suggested by the European Investment Bank in its 2013 Working Paper on Private Infrastructure Finance and Investment in Europe.

4. Provide suggestions to remedy the issue in your example.

Where third country funds and managers are supervised according to equivalent regulatory standards, there is no justification for their exclusion. Such exclusion undermines the openness and international attractiveness of the EU capital market and works against the objectives of CMU.

We believe that the rights to manage and market ELTIFs should be extended to AIFMs in third countries which demonstrably operate equivalent supervisory standards - specifically those third countries that ESMA has determined should have no obstacles to the extension of the AIFMD passport.

[2] European Investment Bank, Private Infrastructure Finance and Investment in Europe, EIB Working Papers 2013/02.

[3] 2015 Prequin Global Private Equity and Venture Capital Report.

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Unnecessary regulatory burdens

Issue 5 – Excessive compliance costs and complexity

1. To which Directive and/or Regulation do you refer to in your example?

2011/61/EU Alternative Investment Fund Managers Directive

2. Please provide an executive/succinct summary of your example

Duplicate costs and duplicate administrative burdens at Member State level act as a barrier to efficient cross border marketing of professional funds in the EU and discourage fund promoters from marketing across European internal borders.

Our response to this point is based on evidence we submitted to ESMA during its Call for Evidence on the functioning of the AIFMD passport and national private placement regimes. ESMA's published opinion[4] made clear that this was a common concern and that, significantly, there were analogous concerns for the efficient functioning of the intra-EU AIFMD passport. There are numerous examples of references to concerns regarding duplicate fees[5].

Our experience of NPPR is that it has only functioned well in a number of Member States. The administrative burden of some Member States' regimes actively discouraged applications, and as ESMA itself recognises, some Member States' regimes preludes third country access outright. We have examples where such an approach led to promoters being dissuaded from operating in certain markets. These effects are not limited to the workings of the NPPR but are amplified through the duplicative costs – monetary and resource – associated with the operation of the passport regime as evidenced by ESMA's published opinion[4].

The economic impact of such practices is to reduce the numbers of funds accessible to European investors, leading to lower levels of market based investment and ultimately undermining the goals of CMU.

3. Provide supporting relevant, verifiable empirical evidence

Our analysis (see figures 1-3) of the data published by ESMA in its Advice[6] on the application of the AIFMD passport to non-EU AIFMs and AIFs demonstrates that the UK's share of marketing of Article 42 funds is by far the largest and that it increased over the period under review. The data also demonstrates that the share of those jurisdictions where NPPR was

[4] ESMA's opinion to the European Parliament, Council and Commission and responses to the call for evidence on the functioning of the AIFMD EU passport and of the National Private Placement Regimes.

[5] For example point 56 of ESMA's opinion to the European Parliament, Council and Commission and responses to the call for evidence on the functioning of the AIFMD EU passport and of the National Private Placement Regimes outlined the additional fees for passporting rights charged by six different competent authorities (where admittedly the passport was functioning and in operation) averaging €1800 per AIF.

[6] ESMA's advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs.

determined to be working well also grew at the expense of the rest (see figure 3). We are aware of numerous funds where marketing into various EU members states has been attempted and aborted (as a result of many of the reasons outlined in 2 above) leading in certain instances to launches being pulled – an experience consistent with the published data.

We estimate, for example, that if the growth in numbers of Article 42 funds in the rest of the EU had been at the rate of the fastest growing market, Sweden, for Article 42 funds[7] a further 2,000 funds could have been launched. More generally, if the growth in the rest of the EU had matched the average of the named EU Member States, the EU could have seen a further 500 funds launched. Assuming an average fund size between €50m to €100m this equates to a further €25bn to €50bn of funds marketed into Europe. Of Channel Island funds marketed in the EU, typically around 50% of assets are located within the EU. If this parameter applied across all Article 42 funds the result would have led to a further €12.5-€25bn global capital flows into EU investments.

Figure 1: Location of marketing of Art 42 funds (share of total by EU MS) (ESMA Evidence Q3)

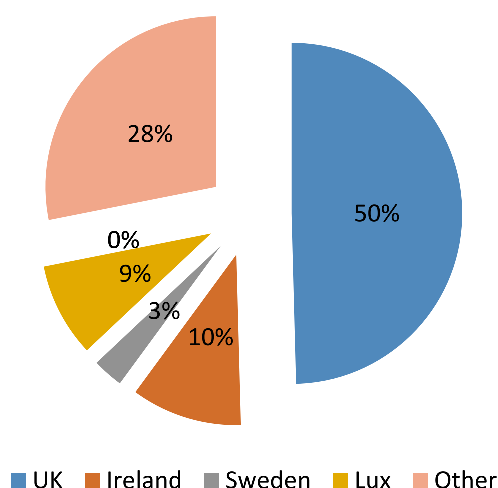
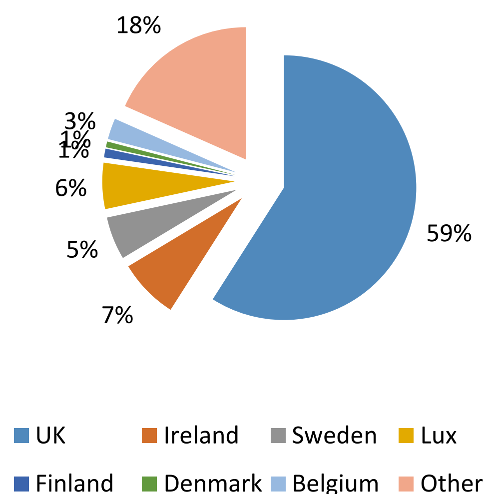


Figure 2: Location of marketing of Art 42 funds (share of total by EU MS) (ESMA Evidence Q4)



[7] Sweden which experienced growth of 4.1 times over the period.

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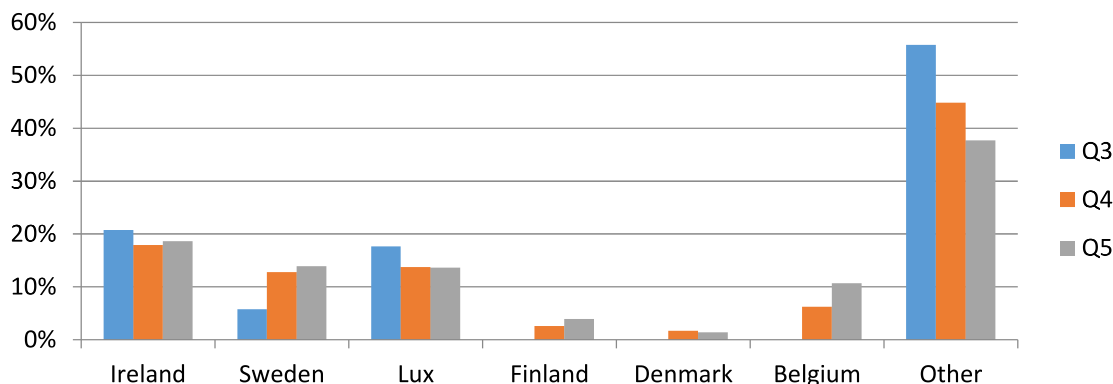
Figure 3: EX UK: Location of marketing of Art 42 funds
(share of total by EU MS)
(ESMA Evidence Q3-Q5)



4. Provide suggestions to remedy the issue in your example.

We suggest a removal of all additional fees and administrative barriers outside the host or Member State of reference for authorised AIFMs and their AIFs together with an immediate extension of the passport to third country jurisdictions passing ESMA assessments.

Unnecessary regulatory burdens

Issue 9 – Barriers to entry

1. To which Directive and/or Regulation do you refer to in your example?

Various – EuVECA, CRR, MIFID II etc.

2. Please provide an executive/succinct summary of your example

Improved market access enabling the free flow of capital will be provided by a more transparent, predictable equivalence process that operates consistently on a dossier by dossier basis.

Attracting international capital is central to the CMU's objectives. Providing market access to international firms that demonstrably meet equivalent regulatory standards, and the capital that is invested in jobs and infrastructure as a result of their activity, supports those objectives.

The inclusion of clearly set out, transparent and predictable equivalence processes on a dossier by dossier basis delivers two benefits. First, it facilitates third country firms' market access and thus better supports the free flow of investment capital into the EU. Second, it extends the territorial regulatory reach of the EU on regulatory matters, in effect strengthening its regulatory perimeter.

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Currently uncertainty extends not just to the specific equivalence processes themselves but also to the fact of their inclusion or otherwise on individual dossiers (see supportive evidence below).

If the CMU objectives are to be fully met, we believe that a clear process for determining equivalence is included as an integral part of all future dossiers, but on a consistent dossier by dossier basis. The key components of equivalence assessments need to be clear outcome-based assessments with pre-defined criteria set out in (level 1) legislation and transparent assessment procedures and timely deadlines set out in legislation.

Equally important is the need for those existing publicly prescribed processes to be dutifully followed in practice. We believe that failure to do so will undermine global investors' confidence in the EU's commitment to free trade and the free flow of capital.

3. Provide supporting relevant, verifiable empirical evidence

Our experience with equivalence processes to date demonstrates their variableness:

- Following the assessment process set out in Article 67 of AIFMD – a process in which we happily participated and we can confirm we found to be rigorous, fair and transparent - ESMA determined that no obstacles existed to extending the AIFMD passport to the Channel Islands, yet at the time of submission (January, 2016 some six months later) no extension has occurred.

- The Channel Islands were determined to have equivalent regulatory regimes under CRR for credit institutions for the purposes of operational risk as set out in Commission Implementing Decision (2014/908/EU). No such positive assessment was forthcoming for investment firms, although the lack of transparency involved in the process means we have yet to ascertain whether this was as a result of a lack of a positive assessment or that we were just not assessed.

- This inconsistency is emphasised by the fact that both ELTIF and EuVECA lack a third country dimension. Most recently the European Council's general approach on the proposal for a regulation on STS securitisation removed the ability for all third countries to participate, running completely counter to the clearly stated intention in the Commission's proposal.

The communication and clarification (when it occurs) of equivalence processes are ordinarily reserved to a point after the final texts of dossiers have been agreed and ratified by the EU. This results in a period of exclusion from the market for third country firms. This practice becomes structural by repetition and by design leads to a more inward looking EU market, one which in time might therefore benefit less from international trade.

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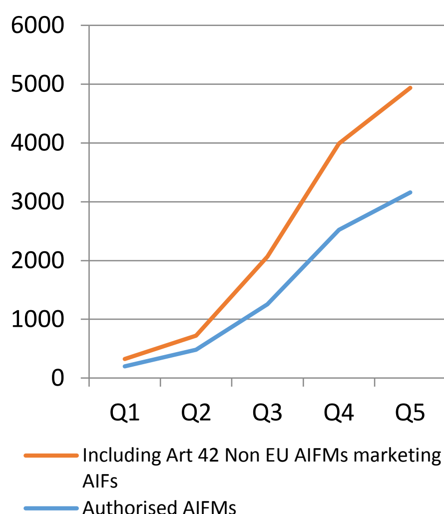

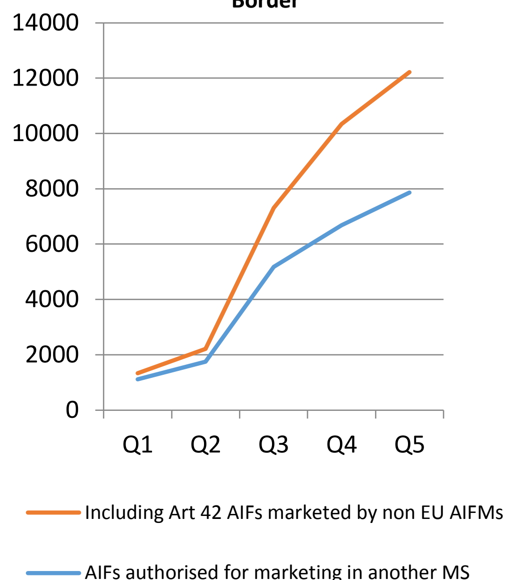

Openness to trade with third countries evidently increases choice available to investors and maximises capital flows. ESMA's data within its published advice[8] on the functioning of the AIFMD passport illustrates the point. Whilst only a fledgling regime and without the full benefit of the extension of the passport to third countries, Figure 4 illustrates that non-EU based AIFMs increased the total number of AIFMs marketing funds in the EU by just over a third. Figure 5 illustrates that non-EU AIFs increased by 50% the total number of funds effectively being marketed cross border in the EU.

If the experience outlined above had been replicated for the EuVECA regime for example, so that third country managers had been permitted to participate in the regime from launch and a similar increase in the funds universe had occurred, up to €600m of additional investment could have been made available through the passport to early stage and start-up European companies.

[8] ESMA's advice to the European Parliament, the Council and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs.

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4. *Provide suggestions to remedy the issue in your example.*

We do not believe the situation requires a horizontal or indeed one size fits all approach but suggest a policy commitment to:

a) Consistently include articles clearly defining an outcome based equivalence process as part of the main (level 1) text within each financial services dossier; and

b) Ensuring that such equivalence processes adhere to certain criteria and parameters on a dossier by dossier basis.

We believe that these criteria and parameters should include:

- Assessments focussed on regulatory equivalence;
- Defined regulatory outcomes against which assessments would be measured;
- Clear timetables and deadlines;
- Defined roles and responsibilities for the ESAs in the process; and
- Open decision process in which third countries can participate.

Rules giving rise to possible other unintended consequences

Issue 14 – Risk

EU rules have been put in place to reduce risk in the financial system and to discourage excessive risk-taking, without unduly dampening sustainable growth. However, this may have led to risk being shifted elsewhere within the financial system to avoid regulation or indeed the rules unintentionally may have led to less resilient financial institutions. Please indicate whether, how and why in your view such unintended consequences have emerged.

1. *To which Directive and/or Regulation do you refer to in your example?*

Delegated Regulation (EU) 2015/35 - Insurance

2. *Please provide an executive/succinct summary of your example*

The Bank of England Financial Stability Paper, Number 33, 2015, 'A European Capital Markets Union: implications for growth and stability' points to the growth benefits generated from

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cross border investment and reduced risk sharing and reduced consumption volatility derived through the capital market channel as potential benefits of the EU's CMU project[9].

Introducing an economic risk-based approach to capital requirements under Solvency II has created a bias towards EU assets and EU domiciled investment funds. The approach judges them to be lower risk by geographic default, specifically in relation to higher risk weightings that apply to assets held in funds domiciled outside the EEA or in non-OECD jurisdictions. We believe that the bias and associated disbenefits are unintended.

Our experience has also been that current wording in delegated acts often unintentionally excludes the Channel Islands, or that is perceived to be the case – even though it is not. This dissuades insurers holding assets domiciled in the Channel Islands. It is likely little known amongst the institutional EU investment community that the Channel Islands are considered part of the UK for the purposes of the OECD[10] and therefore should be properly treated as such for capital risk weighting purposes. The benefits would be an extension of the international capital market channel and, according to theory, at the margin, increased EU growth.

3. Provide supporting relevant, verifiable empirical evidence

The Channel Islands have a highly developed private equity funds market. Research[11] demonstrates that over £80bn in 2013 was invested in continental EU private equity assets through just Guernsey domiciled funds. This is four times the size of private equity assets held in total by European Insurers estimated by Oliver Wyman in 2013[12]. Unintentionally, placing obstacles to insurers holding assets in such a highly developed market within the scope of the OECD is clearly counterproductive.

4. Provide suggestions to remedy the issue in your example.

The European Commission should, through the ESAs, publish formal guidance acknowledging the OECD status of the Channel Islands.

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[9] As explained again in that paper, such benefits are maximised according to neoclassical theory when all investments hold the global portfolio of financial assets (Obstfeld and Rogoff (1996)).

[10] http://www.oecd.org/legal/ukdependenciesterritories.htm/.

[11] 'International Capital Flows: International investment into the UK and Europe: the role of Guernsey's investment funds sector, January, 2015'.

[12] 'Funding the future, Insurers' role as institutional investors', Insurance Europe/Oliver Wyman, 2013.

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Annex 1: The Finance Sectors of the Channel Islands

- The economies of Guernsey and Jersey are services based. In particular over the past 40 years both islands have developed into important international financial centres. Financial services firms are major employers in the islands, with over a quarter of the workforce (19,000 jobs) employed in the sector.

- The combined level of banking deposits across the islands in September 2015 was around £215 billion and the level of funds was £443 billion. These deposits and funds are drawn into the UK and the rest of Europe largely from the rest of the world and the Islands' marketing efforts are directed at increasing this flow from the Far East, Gulf and other wealth creating countries outside of Europe.

- There are 30 licensed banks in Guernsey and 33 regulated banks in Jersey at 2015 and both jurisdictions have local deposit guarantee schemes. Many banking operations are branches or subsidiaries of parent banks based in the EU, including HSBC, BNP Paribas and Deutsche Bank.

- Although Channel Islands funds invest heavily into the UK, it is understood that much of this flows onwards into mainland Europe. Notably there are a number of Channel Islands based infrastructure funds investing in a variety of projects including renewable energy. The activities of these funds support European policy on energy security and reduction of carbon emissions. Indeed the European Commission frequently quotes that more than a third of UK Private Equity (PE) funds' investment goes to companies elsewhere in the EU. This is supplementing the significant direct investment flows from the Channel Islands' funds into the wider (non UK) European economy.

- The wider financial sector of the Channel Islands includes substantial fiduciary and specialist asset management expertise. Both Guernsey and Jersey thus act as "financial entrepôts" and are significant net providers of liquidity and investment funds to the EU economy, directly and indirectly.

- The Channel Islands' largest trading partner is the United Kingdom. Recent information shows that the majority of investment into UK funds channeled through the Channel Islands is from overseas non-European investors. In the UK, Infrastructure funds based in the Channel Islands (including a hub of renewable energy funds) assist with supporting key UK government objectives by facilitating the construction and management of key infrastructure assets across the UK.

- Non-European investors contribute approximately half of the Channel Islands investment into assets in Europe. The Channel Islands funds markets facilitate European investors in achieving their goal of obtaining exposure to global alternative assets. Channel Islands

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expertise in asset management acts as a mechanism to source and facilitate global investors to invest in EU assets.

- The Islands have strong links with capital markets across the globe and are the home of companies that have been the subject of significant listings on worldwide stock exchanges. Companies incorporated in the Channel Islands have had more successful initial public offerings of non-UK entities than from any other jurisdiction in the world. There are 91 Channel Islands companies among the 3,000+ companies listed on the Alternative Investment Market (AIM) of the London Stock Exchange: more than from any jurisdiction except the UK.

- The Channel Islands Securities Exchange provides a listing facility and a market for companies to raise capital from international investors based on a bespoke trading platform serving the interests both of Channel Islands' businesses and of issuers of specialist debt, investment funds and other equity securities from around the world.

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Annex 2: Channel Islands' Regulatory Approach

The Channel Islands are committed to ensuring its regulatory framework and practice meet international standards. It is committed participants in discussions of international standards doing so through their membership of, or association with, the following international organisations.

- The International Organisation of Securities Commissions (IOSCO) - as a member and participating in standing committees C4, C5, C8 and the Assessment Committee
- The International Association of Insurance Supervisors (IAIS) and the Offshore Group of Insurance Supervisors (**OGIS**) - as a member
- The Group of International Finance Centre Supervisors (GIFCS)
- The Organisation for Economic Co-operation and Development (OECD) – as part of the United Kingdom's membership.
- The Council of Europe's Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEYVAL).

Through its membership of the Group of International Finance Centre Supervisors, it works with:

- The Basel Committee on Banking Supervision (BIS)
- The Financial Action Task Force (FATF) on money laundering

The Channel Islands are also committed to international regulatory co-operation and is a signatory to the IOSCO MMoU and the IAIS MMoU. They have numerous bilateral regulatory co-operative agreements in place; and, through ESMA, MoUs covering AIFMD with 27 members of the EEA.

The Channel Islands also has a demonstrable track record of regulatory co-operation and engagement and a demonstrable track record of success in the application of equivalent regulatory approaches to the European Union where there is a relevant contribution by the Channel Islands to the EU markets. In the summer of 2015 ESMA's public opinion was that both islands funds regimes were effectively equivalent under AIFMD and that there were no grounds not to extend the passport to the islands.