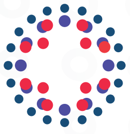

SwissFinanceCouncil

Fostering International Dialogue

The EU & its Partners

Attracting International Investors

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Foreword

We are pleased to introduce the Swiss Finance Council's second Discussion Paper on the topic 'The EU and its Partners: Attracting International Investors.' Following on from our 2015 report, which discussed 'Defending Open Markets in Challenging Times', our most recent work aims to contribute to the policy debate around international investors' and the financial services sector's contribution to fostering economic growth in the European Union.

We are launching this report in awareness of the gradual, yet slow economic recovery in Europe. Several EU Member States have implemented demanding reforms, but there is still too much reliance on the hope that the European Central Bank's expansionary monetary policy will lead to a strengthening in Europe's economic growth. Concerns remain as to several structural issues, including youth unemployment. It remains crucial that the EU continues to address its economic growth challenge and we fully support the investment initiative of Jean-Claude Juncker, President of the European Commission, to complement the ongoing reforms through the European Fund for Strategic Investment and by realising the potential of the private sector through a Capital Markets Union.

We strongly support the Capital Markets Union initiative and in our recent Discussion Paper, we show that international investors can play a vital role in its success. At the same time, our research explores examples of continued barriers in corporate, institutional and private investment in Europe. Finally, our report articulates several recommendations of how existing and new policies can help address these challenges and take greater account of the international dimension when legislating.

The CMU Action plan and the Commission's Call for Evidence provide great opportunities to take the EU's growth agenda forward. We hope you will find our Discussion Paper a valuable contribution to this policy debate and hope you enjoy reading it.

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Executive Summary

Since the financial crisis, economic growth in the EU and its Member States has picked up. However, the pace is still slow and investment activity remains weak. For this reason, growth and jobs have been put at the forefront of EU policy-making. While the progress on fiscal and structural reforms has been slow in many Member States, the European Commission's Investment Plan for Europe (the Juncker Plan) constitutes an important initiative aiming at unlocking public and private investments, which also is a critical part of the EU's Capital Markets Union project.

This Discussion Paper examines how international investors can contribute to the economic recovery in Europe and to boosting the EU's growth potential in the long run. In addition to providing an analysis of the general drivers of investment, the Paper presents three case studies which detail the motivations and requirements of international investors, be they corporates, private or institutional investors. Based on the findings from these case studies, the Discussion Paper proposes ideas on how to stimulate international investments to support growth.

- **Our first case study is based on an exclusive survey of Swiss SMEs**, many of whom invest in the EU. When investing internationally, the surveyed SMEs indicated a clear preference for the EU as destination for their international investments. As their predominant concern time-consuming bureaucracy was mentioned. Despite their limited use of capital markets, about one fifth of the Swiss SMEs consider a common capital market in Europe to be important.

- **Our second case study looks at private investors.** One of the key aims of the CMU is to channel private savings into European investment to a much greater extent than in the past. We looked specifically at how to mobilise the savings of sophisticated investors who often show a strong interest for private equity investments. Private equity is an important source of funding, typically used for financing long-term projects, particularly for SMEs in sectors that are less likely to attract traditional funding. While cultural and historical differences explain the different approaches to investment in Europe and the US, there are a number of EU policies that should be adjusted to encourage private investments. Our Paper recommends that the Commission looks at enhancing regulation, better taxation, and procedural enhancements regarding the registration and distribution of alternative investment products.

- **Our last case study examines two large infrastructure projects** in the UK and the lessons learnt from a financing perspective. The IMF argued strongly, in its 2014 World Economic Outlook, that time is ripe for an "infrastructure push" to stimulate growth. To this end, we discuss multiple funding strategies, including more innovative forms of public involvement, such as contingent guarantees that leave the private sector incentivised for in-plan completion and operation.

Our Discussion Paper develops a number of policy and regulatory recommendations with a focus on removing obstacles which prevent international investors from contributing to the economic recovery of the EU. This includes taking account of the international dimension in its policy-making, based on the following steps:

1. Pursuing an enhanced approach to equivalence determinations for third countries.
2. Communicating the EU's openness to investment from the outside world.
3. Championing consistent international standards.
4. Establishing formal regulatory dialogues with relevant third country authorities.

1 Attracting investment: is Europe fit for the future?

An economic introduction

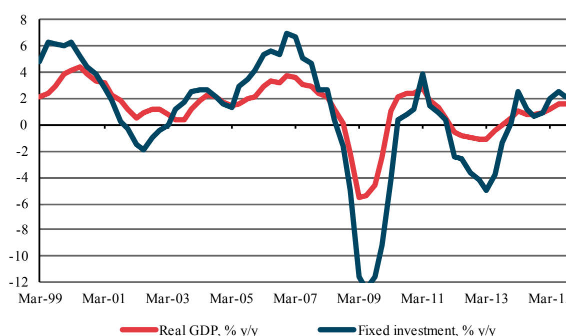
The European Union (EU) has historically been an important destination for international investment. However, investment remains below its pre-crisis level and economic recovery has been slow, and, as a result, the EU is slipping in league tables of competitiveness. Before considering in more detail which policy measures the EU can take to promote investment in Chapter 2, we take a look at the economic context and the challenges Europe faces.

On a global perspective, Europe – and the Euro area in particular – is a low growth area. The problem is partly *cyclical*, as the region still has not fully recovered from the crisis. But the problem is also *structural* as Europe's underlying trend growth rate is relatively low.

Weak investment plays a key role in both the cyclical and the structural weakness of Europe's growth. To illustrate the cyclical dimension, Figure 1 shows that fixed investment in Europe is still subdued. Figure 2 shows that whenever European growth shifted into a higher gear in past business cycles, stronger investment (in red) was a key ingredient – but it is still largely missing in the current upswing.

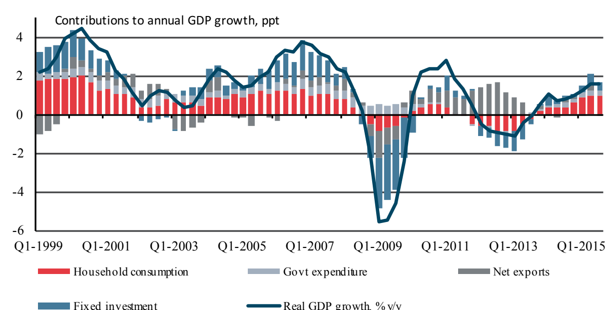
The structural (i.e. longer-term) growth rate of an economy is best described by its *potential output growth rate*, which in the Euro area is only around 1% per year (see Figure 3). Conceptually, potential output growth is driven by the growth of (a) the labour force; (b) the capital stock; and (c) total factor productivity. Investment plays a crucial role in two of the three variables: it contributes to the growth of the capital stock, but it also raises productivity. Consequently, if Europe were able to boost investment, it would strengthen not just the short-term growth momentum, but also the longer-term growth potential.

Figure 1: Eurozone investment still subdued



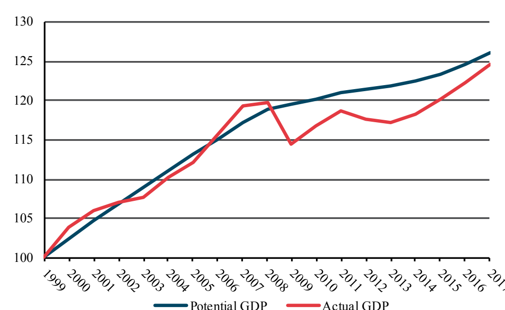
Source: Haver

Figure 2: Investment: the crucial swing factor in the business cycle



Source: Haver

Figure 3: Euro area actual and potential GDP growth - subdued



Source: Haver

1.1 Boosting Europe's attractiveness for investment

What determines a country's attractiveness for investment, from domestic and foreign corporates? There is an extensive body of research that sheds light on this question and a number of quantitative indicators have been developed to facilitate cross-country comparisons, such as:

- The Global Competitiveness Index, by the World Economic Forum;
- The Global Opportunity Index, by the Milken Institute;
- The Ease of Doing Business Index, by the World Bank;
- The Corruption Perceptions Index, by Transparency International;
- Ernst and Young's Attractiveness Survey.

What can we learn from these surveys?

The Global Competitiveness Index[1] takes perhaps the broadest view. It defines competitiveness as the set of "institutions, policies and factors that determine the level of productivity of a country". Productivity, in turn, is a key determinant of the return on investment and hence the strength of investment itself.

The Global Competitiveness Index consists of 12 pillars. The first four (Institutions, Infrastructure, Macroeconomic environment, Health and primary education) are grouped into the "Basic requirements subindex".

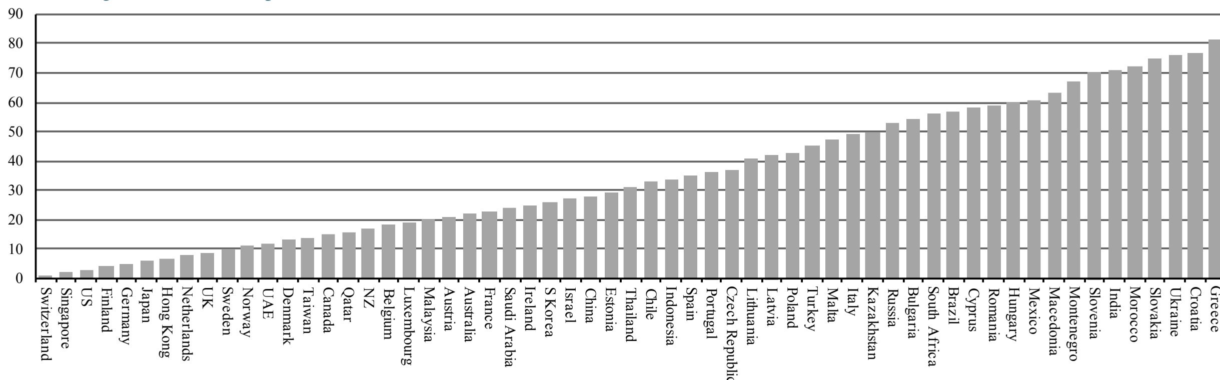
Pillars 5 to 10 (Higher Education and Training; Goods market efficiency; Labour market efficiency; Financial market development; Technological readiness; Market size) are grouped into the "Efficiency enhancers subindex". Pillars 11 and 12 measure Business Sophistication and Innovation. The 12 pillars are not independent, but often inter-related.

The Global Opportunity Index[2] is also rather broad, specifically adopting the views of a foreign investor. It is divided into four categories, with various sub-factors: 1. Economic fundamentals[3]; 2. Ease of Doing Business[4]; 3. Quality of regulation[5]; and 4. Rule of Law.[6]

The perspective of the World Bank's **Ease of Doing Business Index**[7] is narrower; it focuses on ten areas of business regulation.[8] More fundamental factors, such as macroeconomic stability or the quality of the workforce, do not feature.

The Corruption Perceptions Index by Transparency International (TI) measures the perceived levels of public sector corruption worldwide, based on expert opinion. According to TI "Top performers share key characteristics: high levels of press freedom; access to budget information so the public knows where money comes from and how it is spent; high levels of integrity among people in power; and

Figure 4: Global competitiveness index, 2014-2015



Source: Global competitiveness report, World Economic Forum
Note: Numbers represent ranking in index; the lower the number the higher in the ranking.

judiciaries that do not differentiate between rich and poor, and that are truly independent from other parts of government".[9] Surely, these qualities will also help to establish a sound and reliable basis for investment, by domestic and foreign companies alike.

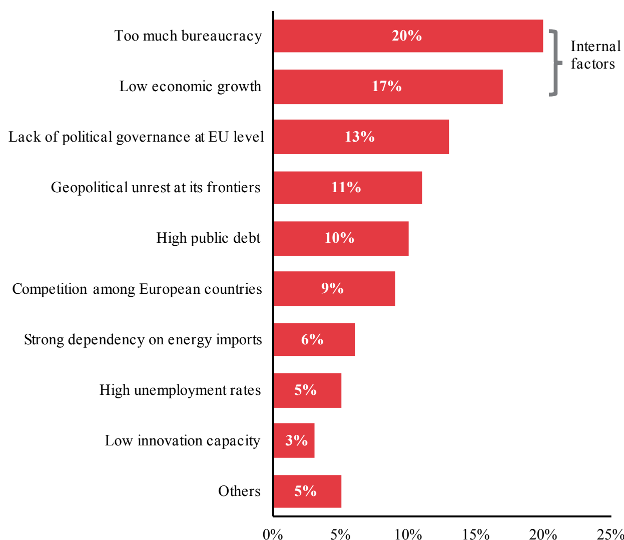
1.2 How well does Europe score in the surveys?

Unsurprisingly, Europe as a whole scores relatively highly in global surveys of attractiveness. However, the majority of EU countries are usually not at the very top of the surveys.

For example, in the **Global Competitiveness Survey 2014-2015**, 15 out of the EU's 28 member states are among the top-40 out of 144 countries globally. But no EU country is among the top-3 (Switzerland, Singapore, and United States). The EU country with the highest rank is Finland, at position 4 (followed by Germany at 5); the lowest is Greece, at position 81.

In the **Global Opportunity Index**, 18 out of the EU's 28 countries are amongst the top 40 out of 135 countries globally. Finland is the best EU country, at positon 3, after Singapore and Hong Kong. Greece and Slovakia have the lowest ranks, at 73 and 75, respectively.

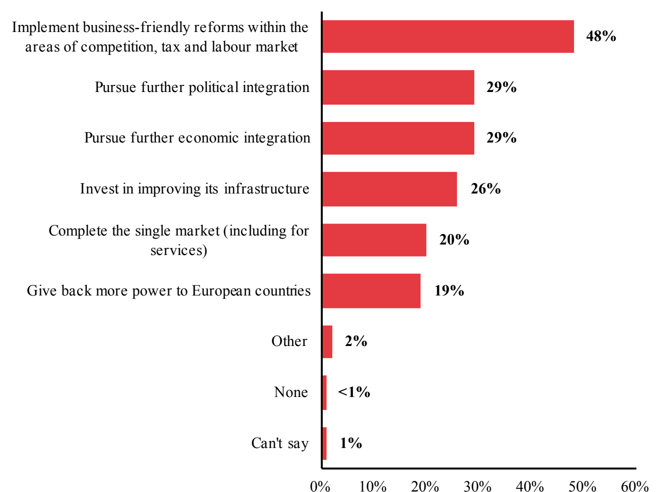
Figure 5: What is the biggest threat to Europe's attractiveness as a destination for foreign investment?



Source: EY's 2015 European attractiveness survey (total respondents 808)

The **Ernst and Young attractiveness survey**[10] (EY) differs from the other surveys mentioned here because it reflects foreign investors' feedback specifically on Europe. According to the 2015 survey, excess bureaucracy and slow growth are still the biggest impediments to investors. As EY note "Geopolitical unrest on the frontiers of Europe, energy insecurity and public deficits are deterrents that pale in comparison to the complexity of rules that straitjacket European employers and entrepreneurs" (see Figure 5).

Figure 6: How should the EU improve Europe's attractiveness?

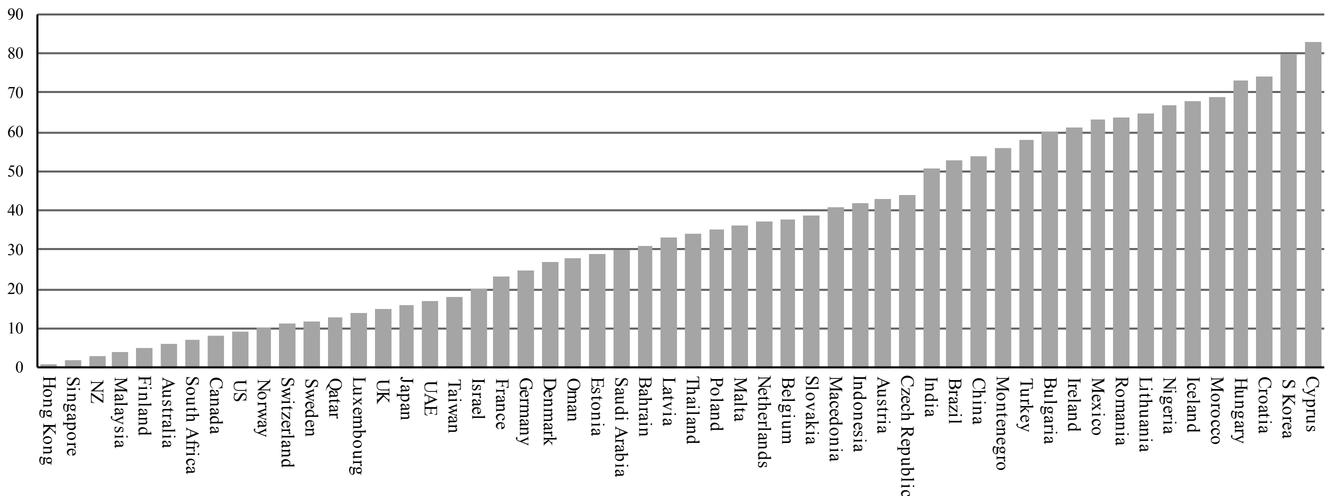


Source: EY's 2015 European attractiveness survey (total respondents 808)

Asked what sort of reforms Europe should implement – see Figure 6 – investors mentioned more business-friendly competition, tax, and labour-market regulation, further political and economic integration as well as **better infrastructure** and the **completion of the Internal Market**, **not least for services**. It is the last two points that we would like to consider in greater detail below.

In Chapter 2, we present a survey conducted by Credit Suisse and Swiss Global Enterprise (S-GE) on behalf of the SFC in which internationally-orientated Swiss small and medium-sized enterprises (SMEs) are questioned about their perception of the EU's attractiveness for foreign direct investment (FDI).

Figure 7: Global Competitiveness Index 2014-2015: sub-index - Financial market development



Source: Global competitiveness report, World Economic Forum
Note: Numbers represent ranking in index; the lower the number the higher in the ranking.

1.2.1 Financial sector: Tapping private wealth to fund investment

Unsurprisingly, surveys of global competitiveness show that Europe's financial sector is highly developed. However, as a result of the global financial and Euro area crises , the relative standing of the European financial sector has slipped in global comparison. In the 2006/07 Global Competitiveness Index, 18 EU countries scored amongst the global top-40 of the Financial Market Development sub-index. However, by 2014/15, only 13 EU countries were represented.[11] Meanwhile, the median rank of EU countries weakened from 29.5 to 38.5 globally.

Some of the slippage in recent years should be reversed thanks to the economic recovery, the efforts by the European Central Bank (ECB) and other central banks to bring the financial sector back to strength and, in particular, the implementation of the Baking Union. Nevertheless, there is now much greater awareness of the limitations of the European financial sector. In particular, there is realisation that:

- non-bank sources of investment funding are still underdeveloped; and
- capital markets in Europe are still not fully integrated – 23 years after the official launch of the EU Internal Market (on 1 January 1993).

Addressing these challenges is a key aim of the EU's **Capital Markets Union (CMU)** project.[12] This should, eventually, also contribute to increasing Europe's attractiveness for foreign investors. Under the leadership of the European Commission, the conceptual work on the CMU is underway (see Box 1).

One of the principal aims of the CMU is to channel private savings into European investment to a much greater extent than in the past. In this regard, we would specifically propose to mobilise the savings of sophisticated investors (from inside and outside the EU) a lot more than is currently envisaged under the European Commission's CMU plans. The second case study in Chapter 2 illustrates the potential of international private investors to contribute to European investments. It also explains some of the issues that currently prevent these investors from allocating funds to Europe and gives some policy recommendations as to how attract more investment.

BOX 1

Capital Markets Union (CMU)

AIM

- Build a true internal market for capital for all 28 EU Member States;
- Overcome current fragmentation along individual countries;
- Increase the relative share of capital market financing (*versus* bank loans) across the EU economy;
- Remove barriers to cross-border investment and lower costs of funding;
- CMU to be established by 2019.

KEY BENEFITS OF CMU

- Boost investment in Europe from the EU and the rest of the world;
- Establish closer connection between financing and investment projects in the EU;
- Deepen financial integration and increase competition.

ACTION PLAN

(A) Short-term action

- Legislative proposals to establish framework for simple, transparent and standardized securitization;
- Review of EU prospectus rules to facilitate access to finance for companies - including SMEs - and simplify information for investors;
- Solvency II: facilitate investment of insurance companies into longer term projects (infrastructure);
- Public consultation on Venture capital and Covered bonds.

(B) Longer term action

Supporting access to finance
- Support venture capital and equity financing;
- Overcome information barriers to SME investment;
- Promote innovative forms of corporate financing;
- Strengthen access to public markets;
- Support equity financing;
- Support infrastructure investment.

Increasing investment
- Increase choice & competition for retail savers (including pensions);
- Expand opportunities for asset managers.

Removing barriers to cross border investment
- Remove national barriers to cross-border investment;
- Improve market infrastructure for cross-border investing;
- Foster convergence of insolvency proceedings;
- Remove cross-border tax barriers;
- Strengthen supervisory convergence.

Source: Questions and Answers on the Action Plan on building a Capital Markets Union, European Commission – Fact Sheet, 30 Sept 2015

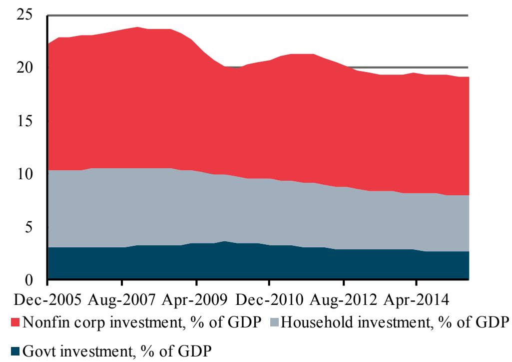
1.2.2 Infrastructure – greater investment through private funding

From an international perspective, Europe's highly developed infrastructure has traditionally been seen as a source of competitive advantage. However, due to the global financial and Euro area crises, there is a perception that many European countries have not invested as much in infrastructure as would have been required to maintain, or raise standards further to satisfy the needs of the modern economy.

As can be seen in Figure 8 and Figure 9, the ratio of investment to GDP has fallen from 23.8% to 19.2% between 2007 and 2015, with the share of public investment declining from 3.2% to 2.7% of GDP. The growth rate of public investment has been negative for most of the time since 2010 and has only recently moved back into positive territory. Importantly, the lack of public investment (and infrastructure investment specifically) is not seen as a problem confined to countries that suffered the most severe challenges during the Euro area crisis, but also more broadly, including in Germany.[13]

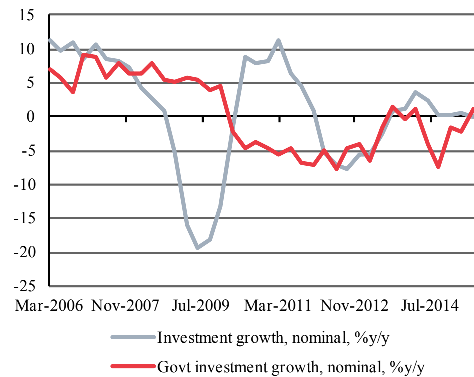
According to the Global Competitiveness Index, Germany and France had the world's best infrastructure in 2006/07, but have declined to rank 7 and 8 in 2014/15 (Figure 10).

Figure 8: Eurozone investment decline



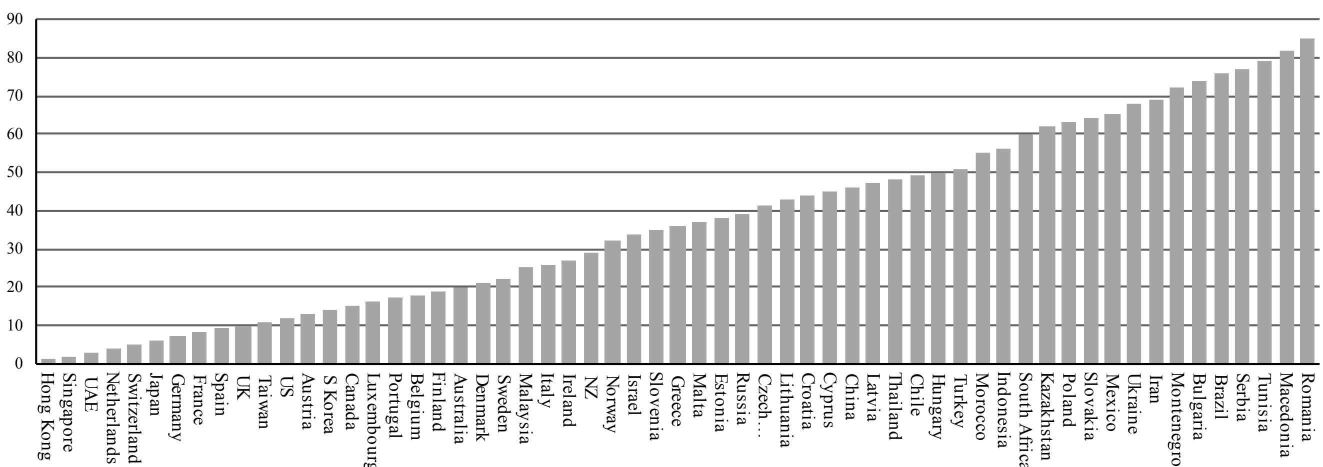
Source: Haver

Figure 9: Eurozone investment growth subduced



Source: Haver

Figure 10: Global Competitiveness Index 2014 - 2015: sub-index - Infrastructure



Source: Global competitiveness report, World Economic Forum
Note: Numbers represent ranking in index; the lower the number the higher in the ranking.

In its October 2014 World Economic Outlook, the International Monetary Fund (IMF) argued strongly that the time was ripe for a big "infrastructure push" to lift growth.[14] While the IMF argued in favour of debt-financed infrastructure spending (to benefit from low interest rates), multiple funding strategies should be considered, including **greater participation of private investors in funding public investment**, **above all infrastructure investment**. After all, the fiscal space of many European countries is limited, given ongoing challenges in public finances, and in those countries where fiscal space does exist the political acceptance of higher borrowing is often limited.

This makes it all the more pressing, in our view, to consider options for greater private funding of infrastructure investment, as we do in the third case study presented in the following chapter.

2 Attracting International Investment: the case of corporate, private and institutional investors

As we have seen in the previous chapter, weak investment activity is a significant hindrance to Europe's long-term economic growth. The most relevant factors affecting investor decisions are a lack of business-friendly competition, tax, and labour-market regulation. Political and economic integration, better infrastructure, and the completion of the Internal Market - not least for services - were also cited by investors as important considerations.

This second chapter therefore explores in three case studies, in more detail, the different investor perspectives:

1. Our first case study is based on a survey of Swiss SMEs, many of whom invest in the EU.
2. the second looks at the potential of private investment as a source of funding.
3. the third looks at two large infrastructure projects in the UK and the lessons learnt from a financing perspective.

Each study shows the need for the EU to take more account of the international dimension to attract investment and suggests a number of concrete recommendations that the EU could take to address this.

2.1 Case study

Attracting corporate investments: the view from Swiss SMEs

As the preceding chapter argues, foreign investment can contribute significantly to growth and welfare in the EU. The EU will be able to attract added capital from its partners if internal market conditions – both "real" and financial – are "right". The current section provides an outside, though admittedly partial, view of the attractiveness of the EU as a location for foreign direct investment, by presenting a survey amongst Swiss SMEs who have been polled on the matter for the purpose of this year's Discussion Paper. The chapter also provides an update of last year's paper which presented a statistical, top-down view of the close partnership between Switzerland and the EU in matters of trade and investment.

2.1.1 Switzerland is the second largest non-EU investor in the EU

Foreign direct investment (FDI) is a key measure of integration and a key driver of growth. The ability to attract investment is also an important indicator and determinant of the competitiveness of a region.[15] In the EU28, total inbound FDI stock amounted to €13.7 trillion at the end of 2014 (the latest data point from Eurostat). According to data from UNCTAD, about 34% of the total world stock of FDI is allocated to the European Union. Europe's share thus exceeds the share of Asia (24%) as well as that of the USA (18%).

Figure 11: The world scaled to sources of FDI inflows into the EU

Source: Eurostat; Average 2013-2014

Fifty-nine percent of the €13.7 trillion invested in the EU, or €8.1 trillion, originated from inside the EU – a reflection of the integrative force of the EU's Internal Market. Moreover, in excess of half of the intra-EU FDI is originated from three countries: Luxembourg, Netherlands and the United Kingdom (see Figure 11). A significant share of the investments from these FDI-hubs originates from other countries however, and is channelled through these FDI distributors.

Forty-one percent, or €2.3 trillion, of the direct investments from outside the EU originated from the United States. The second largest non-EU investor is Switzerland with €0.6 trillion; next comes Canada with €0.2 trillion. This makes Switzerland a more important source of FDI for the EU than Asia, whose aggregated FDI in the EU amounted to €0.5 trillion. Figure 11 illustrates graphically the significance of Switzerland as a source of FDI in the EU. The scale used in this map is not geographical size, but the importance of countries as sources of FDI flows for the EU (areas correspond to shares of FDI in EU in the 2013-2014 period).

At first sight, the importance of Switzerland might come as a surprise, given its small size in GDP terms. However, the very close trade integration between Switzerland and the EU, especially of an intra-industry nature, tends to boost FDI flows. Even when trade barriers are already very low for goods, as is the case between Switzerland and the EU, companies may benefit substantially from being geographically closer to their customers. Other factors that intensify relationships between countries, such as the sharing of a language or other political, cultural, and legal affinities have also been shown to facilitate FDI as well as trade. Switzerland and the EU have both a long history of economic integration and very intense trade relationship. These ties deepened further since the Free Trade Agreement between Switzerland and the EU was concluded in 1972, and the various other treaties that followed. In large part due to these ties, industries in the EU and Switzerland have integrated via joint supply chains, as shown in the latest OECD data discussed later in this chapter.

We have updated last year's investigation on the determinants of FDI flows for highly developed countries based on an econometric model. The model resembles a "gravity model" often used in the analysis of bilateral trade flows. Our sample comprises 245 bilateral investment relationships between 19 OECD countries as well as China and Brazil over the period from 1991 to 2012 (tax data only up to 2005). Obtaining relevant tax data is one of the greatest challenges in this regard. To gauge the tax benefits of investing abroad versus investing at home, we used so-called "effective" tax rates. Effective rates calculate the difference between the pre and post-tax earnings of a project and are thus better suited than "raw" statutory tax rates. However, even the effective tax data based on Devereux, Griffith and Klemm (2002) is unable to account for all special tax regimes. Nevertheless, the results of our analysis suggest that the following factors are important drivers of FDI:

- **Tax rates**: A one percentage point increase in "effective" average tax rate (EATR) of the FDI host country lowers the amount of incoming FDI by 0.2% on average. Devereux Griffith and Klemm estimate EATRs of 30%, 24% and 11% for Germany, Switzerland/Netherlands and Ireland respectively for 2005. In reality, Switzerland and the Netherlands are likely to be just as attractive as Ireland for specific investment projects which suggest that the shortcomings of tax data tend to lead to an underestimation of the effects of FDI.
- **Stability**: A one percentage point higher unemployment rate lowers incoming FDI on average by 0.5%. The unemployment rate can be read as a proxy for both economic and political stability. That said, stable and intense trade relationships should facilitate FDI flows, too.
- **Population**: A 1% larger population attracts on average 0.03% more FDI.
- **Other factors** affecting FDI significantly are geographical distance, the cultural affinity with the FDI sender and the market size (measured e.g. by credit volumes outstanding).

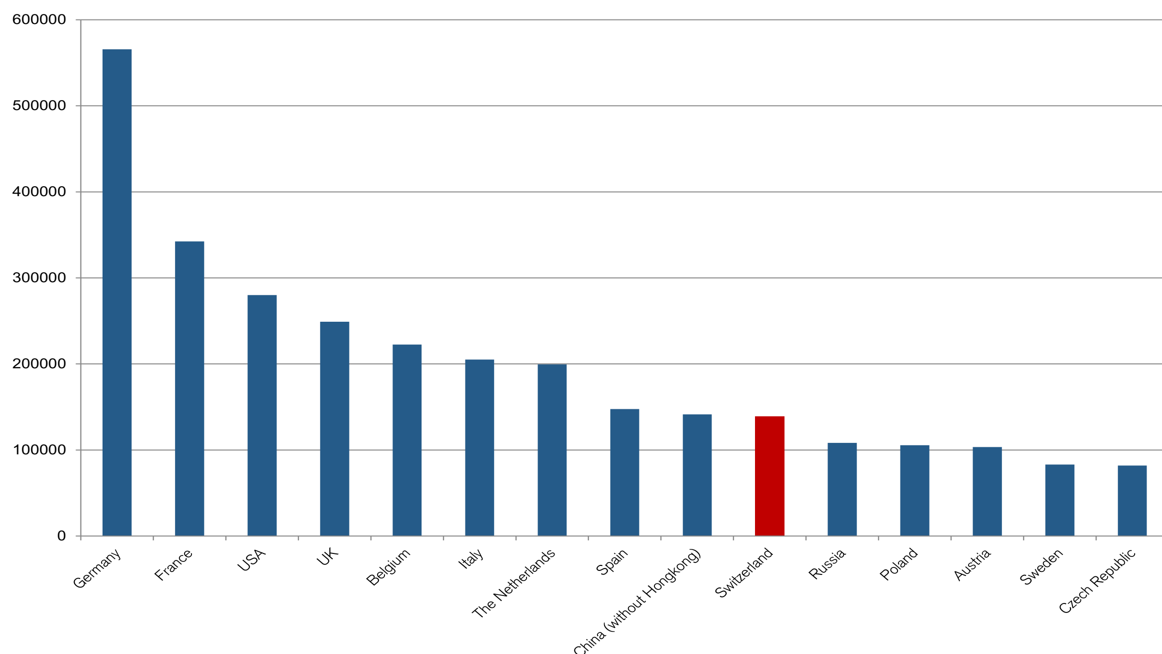
2.1.2 The EU and Switzerland: A stable and intense trade relationship

Switzerland has been one of the top three non-EU trade partners of the EU throughout the last decade. Switzerland ranks among the top buyers of EU goods (including EU Member States), somewhere between Spain and Poland. This makes it the 10th most important destination for EU exporters. A considerable share of the EU-Switzerland trade consists of investment goods, mainly machinery and equipment. Twenty-four percent of the EU exports to Switzerland are investment goods used in production. According to the Swiss Federal Customs Administration 24% of Swiss goods exports to the EU are likewise used for production in the EU.

Switzerland's and the EU's trade interconnectedness is also reflected in value added data published by the OECD. According to this data over one-fifth of Switzerland's exports consist of foreign value added, i.e. of imported intermediate goods and services. The majority of these goods and services, around 14% of Switzerland's total exports, or over 32 bn EUR originate from the EU.

The goods trade relation between Switzerland and the EU is very stable, even in crisis periods. During the Eurozone crisis of 2010-12, Switzerland proved to be an important buyer of EU goods. And with the appreciation of the Swiss Franc (CHF) in January 2015 exports from the EU to Switzerland continued to grow notwithstanding the loss of momentum in the Swiss economy. A part of this trend can be explained by the strengthening of the CHF; the price of EU goods dropped by an average of 12% in 2015. However, the key drivers of this close trade integration are arguably Switzerland's geographical proximity to major EU markets, highly developed transportation linkages, and political ties which have supported a multi-century history of economic integration and trade relations.

Figure 12: The 15 most important export destinations for EU exporters



Source: Eurostat
EU28 exports in EUR Mio., average 2010-2014

2.1.3 Swiss SMEs have a clear preference for investing in the EU

More than 20% of the Swiss SMEs that participated in a survey of Switzerland Global Enterprise (S-GE) and Credit Suisse plan to invest abroad in 2016; 56% (also) intend to invest in Switzerland.[16] With a share of 63% the EU will be the most important target region for the planned investments. Almost one third of the SMEs plans to increase its FDI flows into the EU, while about two thirds plans to maintain the current pace. Only 8% intend to invest less in the near term future. The strong focus on the EU does not come as a surprise given the close trade relationship: About 90% of the participating SMEs export products or services to the EU and 80% source products or services from abroad – with products and services from the EU commanding a share of 78%. Clearly, as a result of the significant appreciation of the CHF against the EUR shifting production or services facilities abroad has become even more attractive.

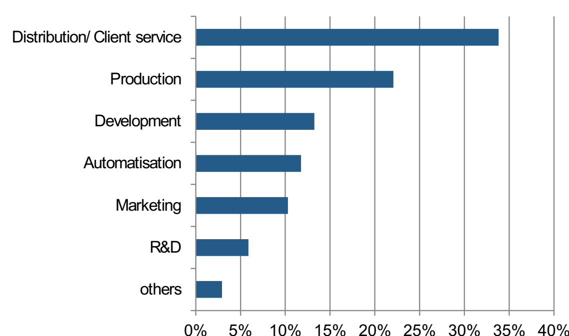
With their investments in the EU the SMEs that participated in the survey aim first of all to improve their supply chains (34%), secondly to save production costs (22%), or thirdly to enter into new markets (6%). Accordingly, Swiss SMEs invest in the EU primarily in distribution and production capacities (figure 13). While the strong CHF against the EUR clearly seems to be leading to an acceleration of foreign investment activities by Swiss companies, the long term trend is due to the other factors mentioned above.

2.1.3.1 Red tape is the biggest concern, while EU institutional questions are not in focus

On a structural level, only 45% of the Swiss SME surveyed say that they have seen improvements in the EU as a place to invest in recent years. According to 43% of the SMEs surveyed, the biggest threat to Europe's attractiveness as a destination for foreign investment is too much bureaucracy (figure 14). High sovereign debt levels and low economic growth are the second and third most mentioned threats. However, considerably less importance is assigned to these factors.

Figure 13: Swiss SME build up distribution and production capacities in the EU

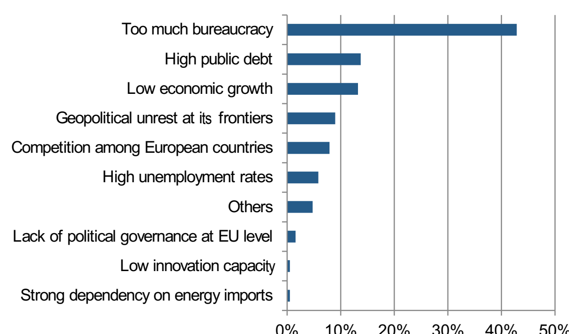
Survey question: Which business segment(s) attract foreign investment? (more than one answer possible)



Source: S-GE, Credit Suisse

Figure 14: Swiss SME perceive the EU as too bureaucratic

Survey question: What is the biggest threat to Europe's attractiveness as a destination for foreign investment?



Source: S-GE, Credit Suisse (question based on the Ernst and Young attractiveness survey referred to in previous chapter)

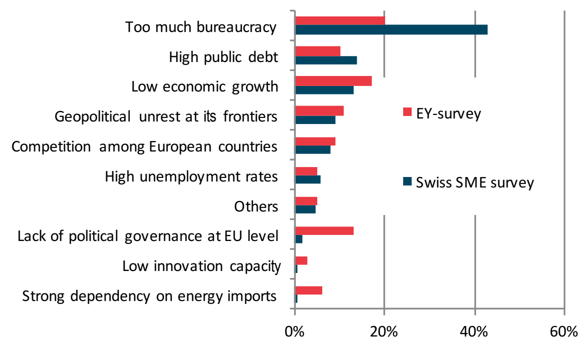
Interestingly, the results of our Swiss survey differ in some significant points from those of the Ernst and Young attractiveness survey (EY) discussed in chapter 1, although the questions are precisely the same. In contrast to the international investors in the EY-survey (the EY panel consists of companies from all over the world which have established operations in Europe), Swiss SMEs weight the (perceived) excess of bureaucracy in the EU much more strongly than do global investors (see figure 15). Our guess is that this reflects the fact that Swiss SMEs are generally operating in a somewhat less bureaucracy-"ridden" environment in Switzerland, whereas international companies confront this problem at home as well. (It should also be noted, however, the Credit Suisse Survey of Swiss SMEs that has been conducted within Switzerland over the past years also throws up bureaucracy and regulation as a key negative factor for Switzerland itself).

Conversely, the weight of weak growth and high public debt is somewhat lower in our survey than in the EY survey, although also amongst the top three complaints. The "lack of political governance at an EU level" does not seem to bother Swiss SMEs, in contrast to what the EY survey says. One possible interpretation is that Swiss SMEs are used to operating in a very decentralized political system in their home market. A second interpretation is that the Swiss companies we surveyed tend to be smaller than those surveyed by EY and that the former thus tend to operate more within national markets than across the entire EU; in transnational operations a divergence between national rules and regulations is likely to be felt more keenly.

Asked what sort of reforms Europe should implement (a follow-up question similar to the one in the EY survey featured in chapter 2) half of all Swiss SMEs mentioned business-friendly reforms within the areas of competition, tax and labour markets as being of greatest importance. This is very much in line with the findings in the EY survey. The wish for further political and economic integration and the advice to give back more power to individual European countries balance each other out (both were mentioned by about 10% of the participants). Another 10% express a wish for a better infrastructure in Europe.

Figure 15: Bureaucracy less dominant topic for non-Swiss companies

Comparison of the two surveys on the questions regarding the biggest threat to Europe's attractiveness



Source: S-GE, Credit Suisse, EY

Similar to the EY survey, reforms of the financial system do not rank amongst the most prominent concerns which may be related to the way SMEs typically finance themselves (see below).

2.1.3.2 Cash flow is the preferred financing source for Swiss SMEs

Two thirds of the Swiss SMEs finance their investments in the EU with their own cash flow, 13% use bank loans provided by Swiss based banks, and 7% with loans provided by EU-based institutions. Only 2% source their financial needs on the capital market (in equal parts in Switzerland and the EU). Despite the so far limited use of the capital market about one fifth of the Swiss SMEs consider a common capital market in the EU as an important project. Asked what the biggest hurdles to financing via the capital market are Swiss SMEs mentioned legal requirements

(31%) and higher capital costs (29%) as the most important, followed by the need to adapt accounting standards if capital markets were to be accessed (22%). A single and well-designed capital market which would lower the costs of capital would thus be highly appreciated by Swiss SMEs.

2.1.4 Recommendations

Small and medium-sized enterprises form the backbone of Europe’s economies. They are at the heart of job creation, investments and innovation. SMEs can also play a crucial role in cross-border investments. This is particularly true for SMEs from Switzerland which are very integrated into the European economy. What are the key conclusions of our survey?

2.1.4.1 Reduce red tape within member economies by promoting best practices

Swiss SMEs believe that the biggest threat to Europe's attractiveness as a destination for foreign investment are unnecessary layers of bureaucracy. Less ‘red tape’ would stimulate third-country SME investment. Such barriers are not necessarily of an EU-wide nature. Nevertheless, our survey shows that often EU regulation adds further constraints to those already existing within the Internal Market. EU authorities should seek to develop a mechanism which would promote best practices based on the experiences of the different member states, as well as non EU countries.

2.1.4.2 Enhance SME access to finance by promoting CMU and Banking Union implementation and completion

High sovereign debt levels and low economic growth are the second and third most mentioned threats. SMEs need a stable macro-economic environment. Today, most SMEs finance their investments from own funds (i.e. retained earnings) rather than from capital markets. Despite the limited use of the capital market about one fifth of the Swiss SMEs consider a common capital market in the EU as an important project. A single and well-designed capital market would lower the costs of funds and would be highly appreciated by Swiss SMEs. From their perspective, it is therefore important to develop alternative flexible funding mechanisms in the context of the CMU. In addition, strong banks can add to the funding sources of SMEs. A key recommendation is thus to both complete and strengthen the European Banking Union and to achieve a well-developed CMU which will, over the longer-term also support investment activities of domestic as well as foreign SMEs.

2.1.4.3 'Think Small First' to foster overall conditions favourable to SME investments

Half of all Swiss SMEs mentioned business-friendly reforms within the areas of competition, tax and labour markets as being of greatest importance. Going forward, investment opportunities would improve if European policies focussed more resolutely on Small and Midcap companies. European and national policy makers are thus encouraged to improve the overall conditions in which SME businesses can thrive. This is because small companies are disproportionally impacted by ill-conceived regulations and bureaucracy. Our findings underline the importance of the Commission’s 'Small Business Act' which encourages policy makers to 'Think Small First'. Legislation, administrative rules and procedures should be simple, easy to understand and to apply. SMEs' interests should be taken into account at the very early stages of policy making in order to make legislation more SME friendly.

2.2 Case study

Making Europe more attractive for international private investors

2.2.1 Introduction

Investment activity in recent years has increasingly been focussed on short term opportunities, as companies, institutional investors, governments and private investors have all seemed reluctant to commit to long-term projects. Globally, cash holdings in the portfolios of High Net Worth Individuals (HNWI) still account for 25.6% of total wealth and remained fairly stable over the last three years.[17] The low interest rate environment indeed offered few fixed-income investment alternatives, yet the global stock market has had a very strong performance until recently. Especially at a time when the need for investment is acute and in an environment where financing multi-year ventures that will further boost economic growth and investment returns seems attractive, the current investment drought comes unexpected, not only from an economic perspective but also given the high percentage of cash deposit in investors' portfolios in a low-interest rate environment.

The case study outlines how Europe could become more attractive to international private investors with a focus on the fast growing Ultra High Net Worth Individuals (UHNWI) population and their interest to invest in alternative investment products, in particular private equity investments[18] that are typically used for financing long-term projects. Private equity invests for the long term and backs over 25'000 companies in Europe, 83%[19] of which are small and medium enterprises (SMEs), in sectors as diverse as life sciences, retail and energy. It also backs impact investing projects that are designed to achieve a positive social impact as well as a financial return in sectors like healthcare. In order to encourage international investors to commit to long-term financing, however, such investments need to be accessible and the overall investment framework needs to be attractive. This requires for example the Internal Market to function so that companies in one Member State can receive investment from another and can use the Internal Market as a springboard to exploit international opportunities. Also the EU has to be open to investors across the world. This case study will address these topics and is structured along three sections.

Section 1 outlines characteristics of the UHNWI market and latest developments from a client as well as an offering perspective.

Section 2 compares the overall investment framework for private equity investments in European companies with the US market and outlines what the SFC considers to be the main issues preventing international private investors from engaging in European private equity investments.

Section 3 then concludes with some policy recommendations on how to attract private investments with regards to the overall investment framework as well as specific recommendations for improving EU policies.

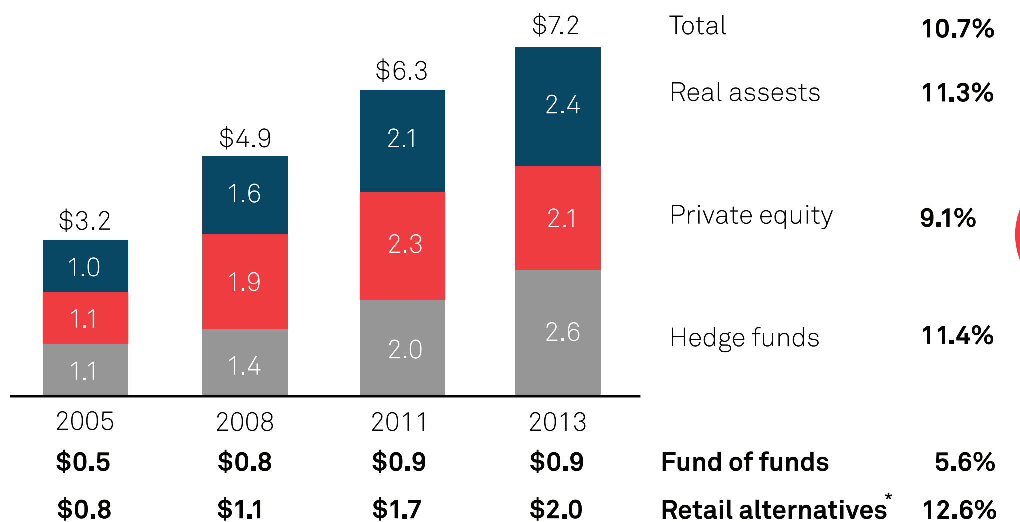
2.2.2 The UHNW market and latest developments

UHNWI are commonly considered to be clients with USD 30 million or more investable assets.[20] While UHNWI make up only 1.0% of all HNWIs, they account for roughly 35% of HNWI wealth and are significant drivers of the overall global HNWI population and wealth growth. Their growth rates in recent years surpassed those of the HNWI. In 2014, for example, global UHNW growth in investable assets reached 9.3% (excluding Brazil).[21] Asia thereby overtook North America in terms of UHNW growth. The UHNWI in Asia now hold more in total wealth, with net assets of USD 5.9tn, than those in North America with USD 5.5tn. However, even if wealth creation is stronger outside Europe, European UHNWIs still control the most wealth with USD 6.4tn.[22] For wealth managers providing cross-border services out of Switzerland, Europe is therefore an important UHNW market.

UHNW clients vary in type but have in many cases an entrepreneurial background and their investment risk profile is generally well suited for long term private equity investments. The active entrepreneur may thereby actively participate in the creation of wealth, whereas for others wealth could be managed via a Family Office. Generally UHNWI with a strong wealth / investments focus have a stronger interest in Private Equity investments compared to clients with a stronger focus on wealth creation through their family or own business.

From a client perspective, it is important first of all to understand their investment objectives. After several years of focusing on wealth preservation post-2008, portfolio performance has become top of mind for UHNWIs. The alternative investment industry overall, including the private equity market, has matured over the last 30 years and is gradually becoming part of the mainstream financial industry.

Figure 16: Alternative investments growing strongly



*Vehicles providing non-accredited investors with exposure to alternatives strategies via registered vehicles: mutual funds, closed-end funds and ETFs.
Source: McKinsey Global Asset Management Growth Cube; Preqin;HFR

Private equity consists of both direct investments in companies, which are often sought by entrepreneurial clients, and investments through private equity funds, which are generally used as part of portfolio management solutions. The interest in private equity as an asset class has surged in recent years as is shown in figure 16 and new trends are developing. For example, UHNWIs who are interested in generating a positive social impact as well as a financial return are looking to private equity-type impact investing collaborations. Single family offices are increasingly interested to participate in networks that allow them to access direct and co—investment opportunities alongside other families. Co-investment opportunities offering more than just capital participation are in high demand particularly with Asian UHNWI wanting to take a direct stake in companies.[23] For clients who were or still are entrepreneurs themselves, this echoes their own experience. Partnering with private equity can hence bring mutual gains and help businesses to grow faster.

From an offering perspective wealth managers providing investment advice build on the client demand and are expanding their platform of capabilities to include private equity. This includes facilitating direct investment in companies or offering fund structures. Facilitating direct investments, however, requires technical skills and knowledge which is often limited to large houses. As such the focus of the wealth managers is mainly on offering fund structures via specialist private equity firms.

From the perspective of wealth managers providing discretionary portfolio management services, proper diversification is an essential element of a sound investing strategy. Hence, alternative investments such as private equity, where properly implemented in a portfolio, are viewed to help lower overall portfolio risk thereby keeping the risk-return relationship attractive. Because their returns typically have low correlation with returns of the broader stock market, these instruments can provide increased portfolio diversification. With an average allocation of over 10% in alternative investments not unusual for UHNWI portfolios,[24] wealth managers are important investors of alternative products globally including private equity on behalf of their clients.

2.2.3 Private equity investments in Europe, main issues and comparison with the US

In 2014, the total amount of private equity investments[25] in European companies increased by 14% to EUR 41.5bn with more than 5'500 companies receiving funding as investments (Figure 17).[26]

While investment in private equity in Europe is growing, the market is small in comparison to the US where over the past 10 years US firms managed to raise almost USD 2 trillion, significantly more than the USD 641bn raised in Europe. In 2014, the number of US based private equity firms amounted to 3'641 versus 1'740 in the EU. The EU private equity investment market is also small in terms of percentage of European GDP compared to the US. In 2014, European Venture Capital investments – a subset of the Private Equity market – equalled 0.05% of EU GDP, while US VC investments were at 0.29% of US GDP.[27]

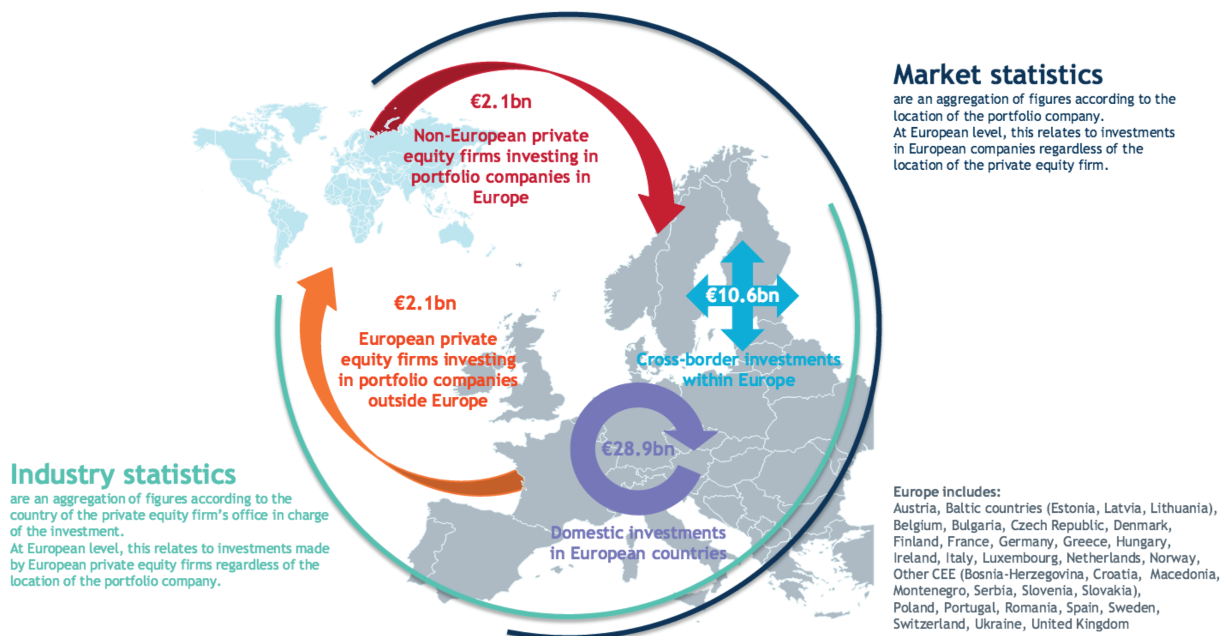
Figure 18 illustrates that private equity firms predominantly invest in their domestic market ("home bias"). The 2014 industry statistics (investments made by European private equity firms regardless of the location of portfolio companies[28] aggregated according to the country of the private equity firm's office) show that EUR 39.5 bn are invested by European private equity firms in portfolio companies throughout Europe with EUR 28.9 bn domestic and EUR 10.6 bn cross-border investments within Europe.[29] At the same time, non-European private equity firms only invest EUR 2.1bn in portfolio companies in Europe.

Figure 17: Overview of 2014 European Private Equity Investment Activity

2014 – Market statistics	All Private Equity	Venture Capital*	Buyout*	Growth*
Amount	€41.5bn	€3.6bn	€31.3bn	€5.6bn
No. of companies	5,519	3,209	945	1,270
No. of firms	1,120	656	467	402
No. of funds	1,740	1,010	631	584

Source: EVCA/PEREP_Analytics
**relates to the investment stage of the portfolio company*

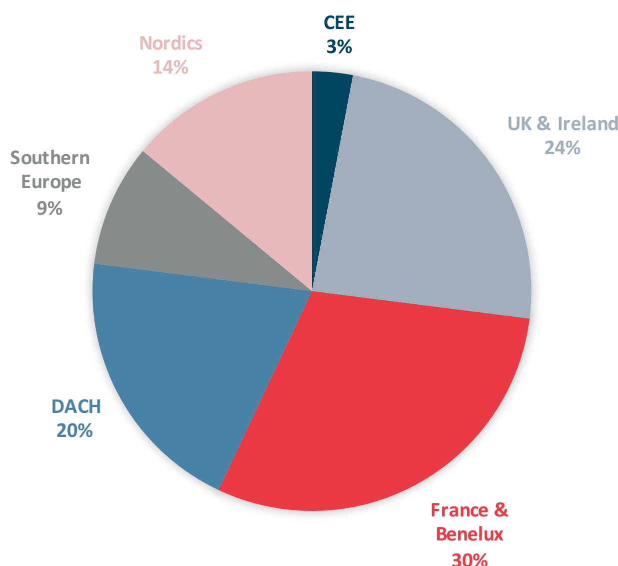
Figure 18: Private Equity Investments 2014 - Geographical investment flows



Source: EVCA/PEREP_Analytics

Although this number has grown, it is still a small fraction of overall private equity investment in Europe. Market statistics also show that investments vary strongly between European countries (Figure 19). The domination of the UK market within Europe and significant capital inflows managed by UK fund managers are clearly illustrated.

Figure 19: European private equity investments by region – market statistics 2014



Source: EVCA/PEREP_Analytics
DACH: Austria, Germany, Switzerland
Southern Europe: Greece, Italy, Portugal, Spain
Nordics: Denmark, Finland, Norway, Sweden
CEE: Central Eastern Europe

Cultural differences as well as the differences in the overall investment framework for alternative investments between the US and Europe provide some explanations for the substantial differences in size and development of the respective markets. The US is traditionally a more entrepreneurial market that fosters and supports a culture for the start-up and development of SMEs and entrepreneurship and where the risk of failure seems better accepted. This development has resulted in both private and institutional investors being more familiar and more comfortable with financing and investing in businesses through alternative investments than in Europe. SMEs in the US tend to favour equity financing, whereas European SMEs suffer from a lack of financing avenues that could provide equity and continue to rely on bank lending. The different development of the capital markets in the US and the EU illustrate this difference. Furthermore, Europe has a tradition of handing over family businesses to the next generation, whereas US entrepreneurs tend to sell their businesses. Also the size of the US single market has helped its growth compared to the EU.

2.2.3.1 The legal framework for alternative investments

In the US the legal framework has strongly supported development of alternative investments from the beginning. The US Small Business Investment Act of 1958 which supported private investment in small businesses and innovation triggered the birth of alternative investments. Additional laws enabled the industry to develop and scale up, particularly since 2000. The Chapter-11 facility is a typical example of legislation that has supported entrepreneurship, recognising that the risk of failure is inherent to entrepreneurship.

Separately from a different cultural background and legal framework there are also some EU policy-related issues which in the view of the SFC discourage UHNWIs from specifically investing in EU private equity funds. These are some examples:

2.2.3.2 Regulatory Regime discouraging private investments

The revision of the Markets in Financial Instruments Directive (MiFID II) includes a broad definition of retail clients in the EU – ranging from basic bank account customers (who need the highest level of protection) to very experienced and sophisticated clients, and a correspondingly narrow definition of

professional clients, with very limited scope for retail investors to upgrade to professional client status. This means that the current definition of retail clients includes a number of highly experienced investors with assets suitable for long term investments. Also many family offices – and thereby UHNW investors - are categorised as retail clients under MiFID. These sophisticated retail investors are, as a result, unduly limited in terms of the instruments they may invest in (with the AIFMD marketing passport being limited to professional clients) and how they can be serviced by investment firms (e.g. based on rules relating to complex versus non-complex products), and also with regard to their scope for geographical diversification, owing to restrictive cross-border rules applicable to using non-EU firms. The current standards effectively cut out UHNW investors who neither trade a lot nor were employed in the financial services industry. The bigger issue is that clients a) have to request the status or service and b) the burden of proof is on the financial services provider to justify the status, which is a hurdle for these firms to classify clients. De facto this means that many private equity investments are simply not available to private investors, not even UHNW investors.

2.2.3.3 Tax systems penalizing private investments

With respect to cross-border equity investment, the punitive nature of the prevalence of withholding tax on dividends acts as a strong disincentive for private investors to consider investing in European private equity. Also the high capital gains tax on private equity investments in some EU Member States discourages private investors domiciled in the respective jurisdiction to consider an investment. Separately, the application of different and generally complex tax rules in EU Member States create an additional hurdle for private investors. They are reliant on tax reporting provided by the fund or the wealth manager, which is costly and labour intensive.

2.2.3.4 Registration and distribution of alternative investment products

Despite the developments of UCITS and AIFMD, which aim at providing EU passports for investment products, registration of alternative investment vehicles remains challenging in Europe. UCITS is designed for retail investors and its regulatory framework does not lend itself well for alternative investments. AIFMD attempts to harmonize national regulations governing alternative investment fund operations, but EU states have implemented its provisions at different rates and have gold-plated their private placement regimes, introducing country-specific restrictions. Registration of alternative investment funds is a big hurdle, which varies from straightforward (in the UK / Netherlands), to difficult (Germany) and unavailable (Italy). This should change when the passport becomes available to non-EU alternative investment funds and managers in 2017/2018, but in the meantime it is very difficult and expensive for off-shore fund managers to distribute on a pan European or even limited basis.

Also administrative processes and red tape for registering funds under the private placement regime are not harmonized across the EU, which has resulted in major difficulties in navigating the patchwork of rules in order to continue to access local investors. A significant number of Member States have introduced additional requirements with the effect that notification by the authorising Member State is often only the first step in a much more complicated, time-consuming and expensive process of obtaining the passport. As a result, what was supposed to be a simple and cost-efficient process for managing and marketing funds in another Member State after receiving authorisation in the Member State of the fund manager’s domicile turned out to be in many cases much more difficult. The most obvious examples are Germany and Denmark, which require the appointment of a depository.

BOX 2 MIFID client classification

The MiFID client classification foresees *three categories of clients*: Eligible counterparties, professional clients and retail clients. The definition of 'professional client' includes all of the entities that fall within the eligible counterparty category. Furthermore, retail clients may be treated as professionals on request (Opt-up professionals). All clients not falling within these categories are considered to be retail clients.

The level of investor protection varies between these client categories. Clients may, either on the initiative of an investment firm or at the client's request and with the consent of the firm, be opted down to a more protective client classification.

The eligible counterparty status is relevant for certain types of investment business, mainly dealing and arranging deals in investments. It is not relevant to, for example, portfolio management or investment advice.

Per-se professional clients possess the experience, knowledge and expertise to make own investment decisions and properly assess risks involved. Clients include (i) entities authorised or regulated to operate in the financial markets, such as credit institutions, investment firms, and collective investment schemes, (ii) large undertakings meeting minimum size requirements in regards to their balance sheet, net turnover and own funds, (iii) international and supranational institutions such as central banks, national and regional governments and others as well as (iv) other institutional investors whose main activity is to invest in financial instruments. **Opt-up professional clients** refer to retail clients who are allowed to waive some of the protections afforded by the conduct of business rules upon their request. For the identification of such clients, assessment criteria – of which two need to be satisfied – are pre-defined and include (i) transactions carried out in significant size on the relevant market at an average frequency of 10 per quarter over the previous four quarters, (ii) the size of the client's financial instrument portfolio exceeding EUR 500'000, (iii) a professional position in the financial sector for at least one year which requires knowledge of the transactions or services envisaged.

Retail clients are all clients which do not meet the definitions set out above, hence receiving the highest level of investor protection.

The MiFID client categories are *not mutually exclusive*. Professional clients may be treated as eligible counterparties depending on the type of business. Retail clients may be treated as professional clients only in regards to services and transactions related to a specific asset class.

The MiFID client classification is *used as a reference in several EU financial product regimes*, such as AIFMD, UCITS and the Prospectus Directive. Typically, these regimes offer relaxation of conditions when distributing products to professional clients.

MiFID client categories by level of investor protection from low to high

Category	Key criteria	Key implication
Eligible counterparty (ECP)	Applicable to a certain subset of per-se professional clients in relation to eligible counterparty business (i.e. provision of the service of reception and transmission of orders on behalf of clients, execution of such orders and/or dealing on own account)	Many of the investor protection requirements do not apply for transactions with an ECP
Per-se professional client	• Authorised/regulated financial market entities • Large undertakings above certain size • International and supranational institutions (e.g. Central banks) • Other institutional investors	Client can be assumed to possess the experience, knowledge and expertise to make investment decisions and assess risks involved
Opt-up professional client	Two of the following criteria satisfied: • Minimum number of transactions carried out • Size of portfolio exceeds EUR 500'000 • Professional in the financial services sector	Client is allowed to waive some of the protections afforded by the conduct of business rules
Retail client	All other clients	Client receives highest level of investor protection, restricted access to investment products

Other jurisdictions like France or Italy have in effect made it very difficult to market funds on any type of private placement basis, either to protect domestic providers or because of the complete lack of a suitable legal framework for private placement. Whereas the UCITS passporting fees have been minimal, with AIFMD the national regulators seem to have adopted more divergent approaches and consequently there is a divergence in cost, and time taken, to register a fund. As a result, the total cost of registering, including legal, tax and regulatory fees, vary substantially across the EU; in the UK registration can be done for £250 with a total expected fees of maybe up to £5'000, whereas registration of a fund in Germany could cost up to EUR 30'000 (or more depending on the complexity of the structure).

This has deterred smaller fund managers from marketing in many countries and quite a number of non-EU based private fund managers who invest in Europe are opting to avoid marketing their funds in the EU completely, or only focus on a few jurisdictions. As a result European private investors miss out on investment opportunities, as these are simply not made available to them due to regulatory hurdles.

In comparison, investment companies in the US, including alternative investment funds, are generally subject to the jurisdiction of the Securities and Exchange Commission (SEC). Generally, advisers having at least $100 million in assets under management are required to register with the SEC, which is a straightforward process. Alternative Investment Funds themselves are regulated pursuant to the Investment Company Act, but most funds qualify for an exemption from registration. Although the Dodd-Frank Wall Street Reform and Consumer Protection Act revised the exemptions applicable to investment advisers, overall the regulatory framework for offering Alternative Investments in the US remains straightforward.

2.2.3.5 Size of European funds

In Europe the landscape is composed of a large range of smaller funds and many of them don't have the track records that attract many new investors. UHNWI as any other investor are looking for competitive returns and profits gained by private equity investments in Europe have been consistently lower in Europe compared to the US. Industry research shows that there is a positive relationship between fund size and performance.[30] European venture capital funds are on average 30% smaller than US funds.[31] This is in particular true for funds with a national focus. Due to the smaller size, they are unable to attract investors who are looking to invest higher amounts. Furthermore, the national focus of many small, largely government-funded venture capital funds discourages private investors, who are wary of the lack of scale effects and the increased risks that stem from low regional diversification.

2.2.4 Recommendations how to attract international private investments

This section provides a number of recommendations on how to attract international private investments, both from an overall framework as well as specific recommendations for improving EU policies.

2.2.4.1 Ease regulatory restrictions on investors by reviewing the retail client classification in the EU

The current client classification under MiFID and conditions for sophisticated private clients to be able to opt up to professional clients should be reviewed with the aim to facilitate investments into private equity. In particular

the condition of carrying out an average number of transactions should be calibrated by asset class to reflect the fact that required average frequency of 10 transactions per quarter are unrealistic to achieve for private equity investments due to their typically larger size and longer term investment horizon compared to other asset classes. Furthermore, the MiFID third country regime which regulates the provision of cross-border services into the EU should allow for opt-up professional clients ("elective professional clients") to be treated as professional clients instead of retail clients. EU Member States should consider reviewing their national market access regimes allowing third country wealth managers to actively promote or market private equity investment to EU domiciled UHNW clients on a cross-border basis.

Additionally, a Private Placement Regime for non-professional clients could be considered. Having a regime like the UK NMPI (Non Mainstream Pooled Investments) in place across the EU would further facilitate access of private investors to alternative investments.

2.2.4.2 Make targeted adjustments to tax systems to incentivize investments by private investors

Further harmonization and simplification of the tax treatment across the EU would improve the overall investment framework and promote equity financing. Governments could also incentivize longer-term or socially productive forms of investment by using the tax system. A system of capital gains tax that ratchets lower as the holding duration increases is one possibility. In the US, for example, capital gains rate falls from 43.4% to 23.8% after a certain threshold is reached. Also the UK has adopted a mechanism of gradual tapering. The Master Limited Partnership (MLP) structure in the US is another example how tax can be used to funnel investment into particular directions. The MLP was established to promote investment in energy production, transportation and processing in the 1980s and individual investors can reduce their tax liability by claiming a share of the MLP's depreciation.[32]

Tax systems should not only allow foreign and domestic private equity investors to pool capital in an investment vehicle, but should also minimize the risk of onerous treatments such as additional or double taxation at the level of the vehicle or on distribution by the vehicle. Foreign investors should also be given certainty with respect to local tax liability. A common EU approach to the tax treatment of private equity funds could be developed. With respect to cross-border equity investment, the withholding tax reclaim procedures could be simplified to encourage greater investment at a global level.

2.2.4.3 AIFMD passport - drive convergence in the interpretation among EU Member States

The AIFMD passport provides Alternative Investment Fund Managers ("AIFM") including Private Equity firms with a harmonised ability to market their funds across different EU Member States. However, the national transposition of the Directive differs considerably between the EU Member states. The current inconsistent interpretation of "pre-marketing" and marketing between different EU Member States as well as different approaches taken (e.g. in regards to additional fees or where rules have been gold-plated) should be addressed. The planned AIFMD review in 2017 should be seen as an opportunity to ensure a harmonized internal market for private equity fund investment across Europe, with rules that are tailored to these industries' characteristics. The European Long-Term Investment Funds (ELTIF) regime, which is currently in development and builds on AIFMD, will create a new product framework to encourage investors to commit capital for the long term. ELTIF is also available to retail investors, and hence could be a good opportunity to attract private investments. Therefore it is important that the new regime offers a harmonized approach and provides the necessary flexibility, not creating similar hurdles as currently experienced.

2.2.4.4 Availability of a pan-European marketing passport to non-EU AIFMs

The pan-European marketing passport which is currently only available to EU AIFMs should also be made available to non-EU AIFMs and AIFs to increase internal market competition and efficiency. Currently non-EU AIFMs are only allowed to market AIFs within EU Member States when complying with the national private placement regimes ("NPPR") of the respective EU Member States. Non-EU AIFMs wishing to market their AIFs throughout the EU today are required to comply with a difficult patchwork of divergent national regulations. As a result a variety of different fee structures and requirements may be imposed by different Member States on a single fund. The non-availability of a passport is a clear entry barrier to non-EU AIFMs as very few, if any, have the bandwidth to register in multiple countries. Following the positive equivalence assessment of Switzerland, Guernsey and Jersey, the regulatory regimes of the US, Hong Kong and Singapore should be assessed as soon as possible (see box for further explanation on equivalence). In this respect, we make some overall recommendations, in the concluding chapter to our Discussion Paper, on how the EU could enhanced the process for making equivalence determinations.

2.2.4.5 Stimulate the development of EU private equity investment funds

A good example of how to make the European market more accessible is the Canadian Venture Capital Action Plan, an initiative to increase private-sector investment in innovative businesses. The plan has made available C$350 million to establish four large-scale private-sector-led funds of funds in partnership with institutional and corporate investors. The role of the government consisted in defining the structure of the action plan and providing financial support to the fund of funds in form of loans.[33] A similar approach could be applied in the EU, whereby fund strategies should privilege and encourage cross-border investment.

The European Commission recognizes the long-term benefits of private equity and the action plan for the Capital Market Union (CMU) also recognises that Europe's alternative investment funds tend to be small and mainly focused on early start-ups. The development of the private placement markets and the review of the Prospectus Directive are indeed important actions. The proposed action to widen the investor base for SMEs also has its merit, but this should also include encouraging equity investment.

The SFC appreciates that the Commission is looking at ways to increase the flow of funds into later-stage companies and small and medium-sized enterprises (SMEs). This might be achieved through tax incentives, allowing larger fund managers to establish funds under the EU Venture Capital Fund Management Regulation (EuVECA) umbrella. Also the new European Long-Term Investment Funds (ELTIF) will contribute to attract private investors to invest in Europe, provided that the regulatory and overall investment framework of this initiative is geared to the characteristics of the UHNW market.

BOX 3

Equivalence

Equivalence assessments are a tool for providing international companies regulated to the same high standards as those in the EU with access to the EU market. A positive equivalence assessment of a third country's regulatory regime confirms that it manages risk in the financial system, delivers consistent investor protection and market integrity, and checks that the regime ensures effective oversight and enforcement. Correspondingly, while waiting for a positive equivalence assessment, EU businesses and consumers are shut-off from service providers and investment opportunities from abroad.

An efficient and timely process for making equivalence assessments therefore would be an advantage to the EU economy, especially while the recovery is weak. However, experience to date has been mixed, with assessments taking a long time, and only a handful having been completed. There are a number of substantive and procedural reasons for this:

- There has been no overriding standard in the different legislative measures, with approaches varying from one to the next. While this is to an extent necessary to take account of the nature of each piece of legislation, the process has developed ad hoc, with little account taken of crosscutting issues or opportunities to simplify processes.
- The criteria have not always been precise, with too much leeway for interpretation, while the basis of comparison has not always been clear. Assessing whether or not third country legislation achieves the same regulatory objectives is often difficult to do.
- The choice of which countries to assess seems arbitrary and unclear. Third countries cannot initiate the process but have to wait for the European Commission to do so, and there are no clear timeframes or deadlines. As such, the Commission retains considerable discretion over the process, reducing certainty for all involved.
- In most cases, EU legislation does not include transitional provisions to address issues raised by possible equivalence assessment delays.

These practical problems put into question market access, even when equivalent regulation is actually in place, or when third countries are willing to implement equivalent rules. Consequently, there have been a number of calls for reform, including from the European Parliament, which in its Report on Stocktaking and Challenges of the EU Financial Services Regulation asked the Commission *"to propose a consistent, coherent, transparent and practical framework for procedures and decisions on third-country equivalence, taking into account an outcome-based analysis and international standards or agreements."* [34]

2.3 Case study

Reviving private investments by institutional investors – focusing on infrastructure investments

2.3.1 Introduction

This case study aims to, first, summarise the initiatives already undertaken or in the pipeline to address improved incentives for investments by institutional investors in infrastructure projects. Second, it outlines, based on two recent successful infrastructure projects in Europe, the regulatory challenges for infrastructure projects, concluding with recommendations for the regulatory framework.

As stated before, estimates show that the public sector has reduced investment in infrastructure, falling as a share of GDP in Germany, Italy and the UK since the financial crisis. Capital spending on infrastructure in the UK, for example, is down by a third in real terms from its peak in 2009, according to figures from the UK's National Audit Office.[35] Estimates suggest infrastructure investment of up to $3 trillion a year for OECD members alone may be needed to maintain and extend infrastructure up to 2030, double the current rate of spending.[36] With many infrastructure projects being public goods, it is important that the public sector retains a strong role in both the construction and financing of these projects. However, in order to raise the levels of capital needed, enhancing the role of the private sector could offer a significant opportunity for Europe's financing needs.

Institutional investors, such as pension funds, insurance companies and sovereign wealth funds, are the investor class with the longest investment horizons, making them an ideal partner for the public sector in respect of infrastructure investments. In the past years, institutional investors have increasingly replaced banks in their role in the financing of the (long-maturity) debt part of infrastructure projects. They represent a customer base that is interested in long-term revenues rather than short-term profit.

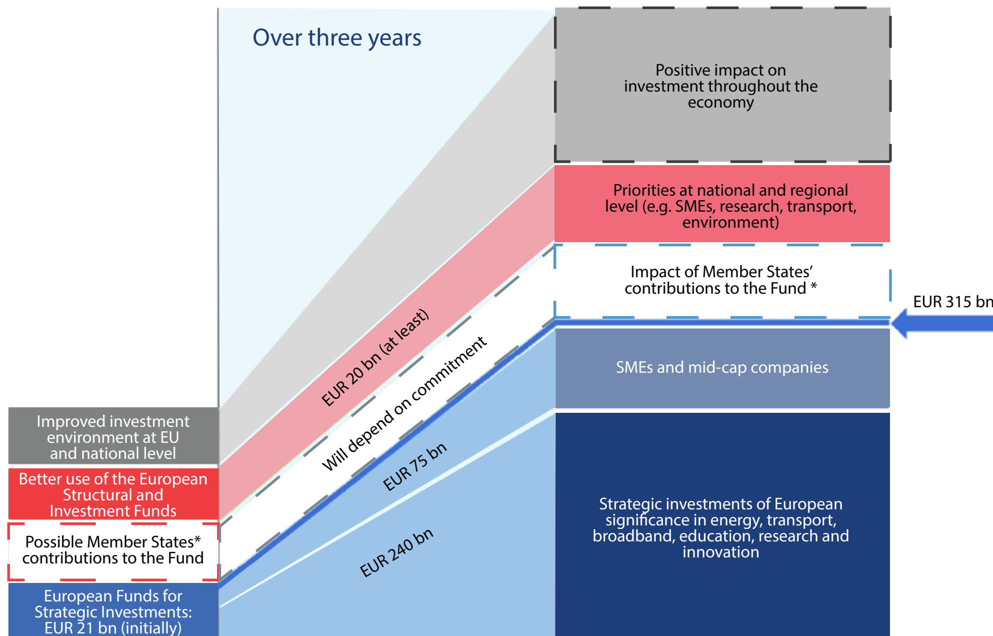
2.3.2 Recent policy developments: The European Fund for Strategic Investment and Capital Markets Union

In 2014, the incoming European Commission identified the lack of infrastructure investments as a significant impediment for growth in the EU. To help tackle this challenge, it proposed a European Fund for Strategic Investment, which came to be known as the Juncker Plan.

In addition to promoting targeted use of the European Structural Funds, the European Commission proposed the European Fund for Strategic Investment (EFSI). The EFSI was quickly endorsed by the Member States, and has been operational since September 2015. It aims to trigger at least €315 billion of additional investment in Europe, by levering EU and European Investment Bank funds of €16 billion and €5 billion respectively three times and then used as a 20% credit enhancement over the next three years. The EFSI targets strategic investment projects (subject to certain selection criteria) in infrastructure as well as risk finance for SMEs. According to latest numbers published by the European Commission, the EIB/EIF have approved financing for infrastructure and innovation projects in the amount of €5.7 billion since January 2016 indicating that the Juncker Plan might gain traction.

Another action of the European Commission was to address under the project of the

Figure 20: Mobilising Finance for Investment - leverage



**In the context of the assessment of public finances under the Stability and Growth Pact, the Commission will take a favourable position towards such capital contributions to the Fund.*
Source: European Investment Bank, Factsheet 2 – Where does the money come from?, http://www.eib.org/attachments/efsi_factsheet2_where_from_en.pdf

Capital Markets Union (CMU) the treatment of infrastructure investments in EU capital requirements legislation for insurers, Solvency II.[37] The goal is to ensure that Solvency II does not impose inadequate or punitive capital requirements by establishing a distinct infrastructure asset class for which the amount of capital which insurers must hold against the debt and equity of qualifying infrastructure projects will be reduced.

The SFC believes that these initiatives are very significant measures to tackle the lack of infrastructure financing. Further enhancements to the regulatory framework and improving the incentives for institutional investors will be crucial to leverage the full potential of Commission's initiatives with the aim of substantially growing the market for infrastructure investments.

2.3.3 Successfully placing infrastructure projects in the private market

Infrastructure projects require attractive value propositions for both the public and the private sector. The SFC believes that it is decisive to strike the right balance between involvement of the public sector and incentives for engagement of institutional investors. Experience shows that the right balance might be very different depending on the type of investment, i.e. for 'greenfield' projects that require funding in the construction phase and 'brownfield' projects; that require financing in the post-construction phase.[38] Greenfield projects are characterised by a high risk structure from construction risks to misjudging cash and capital flows in the initial operating phase. Brownfield projects are typically

characterized less by these risks, but are still different from secondary market investments in Fixed Income or Equity instruments as their revenues depend on the management of an ongoing project. This holds particularly true for greenfield transport and social infrastructure projects where the infrastructure needs public financial support.

We looked at two recent infrastructure projects, one greenfield, the Thames Tideway Tunnel project to modernise London's sewerage system, and one brownfield, the High Speed rail link between London and the Channel Tunnel. We analysed the specific characteristics with a particular focus on their attractiveness for private investors.

2.3.3.1 Greenfield Project: Thames Tideway Tunnel

The Thames Tideway Tunnel (TTT) project aims to modernize the sewerage system in London by building a new tunnel underneath the River Thames through the heart of London. The procurement phase started in mid-2014. The project presented a number of specific challenges due to its financing size, the duration of the construction period, the construction risk and the specific regulatory environment applicable to the project, all of which required innovative answers we believe hold lessons for the broader policy framework.

The TTT project has a total investment of £4.2bn, and the construction period is estimated to last 10 years. The tunnelling risk under a metropolitan area like London is considered to be very high. Timely and on budget completion is a priority for the project's stakeholders – the UK Government, regulator, and water supply company as the old sewerage systems date from the 1860s. For the project this meant the following:

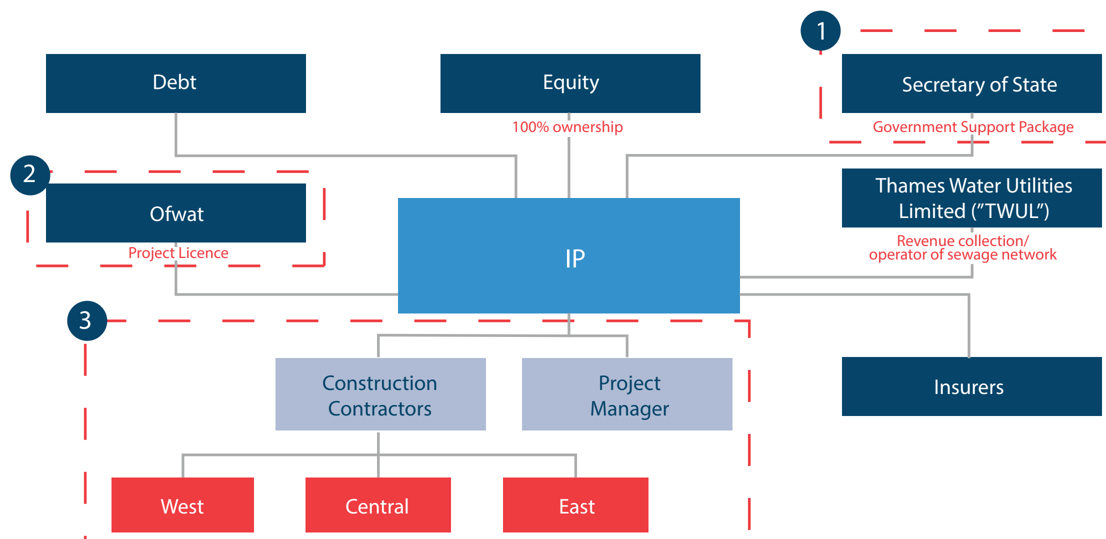
- Traditional public-private-partnership programs (PPP) were not suitable for TTT. Evidence from PPP programmes points to such models working well for simpler, standardised and smaller projects, such as social infrastructure like hospitals, schools, government buildings where the construction/completion risks are modest, and the period of construction short (2-3 years). Consequently, major projects with higher than normal risks can often offer better value for money to taxpayers when financed without private capital as simple public sector procurement.
- The financing size of the TTT was significant and the equity part is greater than usual for traditional greenfield projects. In addition, on the debt financing side, the debt needed to be investment grade to ensure any financing plan was sufficiently robust.

These parameters forced the involved parties to find more innovative solutions compared to their 'simpler' infrastructure projects. Figure 21 illustrates the TTT project structure.

To address the high financing need, the TTT project was deliberately structured to attract large institutional investors, such as pension funds, insurance and sovereign wealth funds. To do this the risk transfer was carefully calibrated to ensure that risks inside the industry norm were assumed by the private investors, whereas risks outside the industry norm were shared with government and end-customers.

Government support (i.e. taxpayer risk sharing) and regulatory mitigants (i.e. customer risk sharing) were used to reduce risks within the TTT project such that the overall risk transfer to the private sector equity and debt providers was similar to that of an operational water investment, i.e. the very low cost part of the infrastructure market. The emphasis was on incentivisation of equity by achieving an Internal Rate of Return (IRR) similar to operational core infrastructure assets.[39] For example if construction costs overrun a pre-agreed amount, Government would cap the funding requirement ensuring that the loss of IRR for private investors is not too high. However, up to that pre-agreed amount, private investors are not getting full return on the additional capital they are required to inject, ensuring

Figure 21: IP structure at a glance



high incentives to make the project work. On the debt side it was crucial to have a structure capable of supporting a BBB rating. Part of the enhanced regulation framework allows for a sharing of risk should the cost of debt exceed the estimation after the start of the construction phase, reflecting the difficulty of raising all finance up-front with such a long construction period.

Other risk mitigants addressed the problem of the long and expensive procurement processes that have made other PPPs unattractive to investors and were responsible for delays. They were focused on efficient project management features – tasks transferred to a separately created project entity (referred to 'IP' in the above chart) - where again control and transparency of risk were crucial.

Furthermore, an additional element contributing to the success of the TTT in terms of attracting competitive private sector capital was the continuous engagement of public authorities throughout the life of the project based on an existing regulatory model for the privatised water sector. This allows for dynamic reactions to the project terms during the construction or operation phases, with the involvement of the public sector guaranteeing continuity.

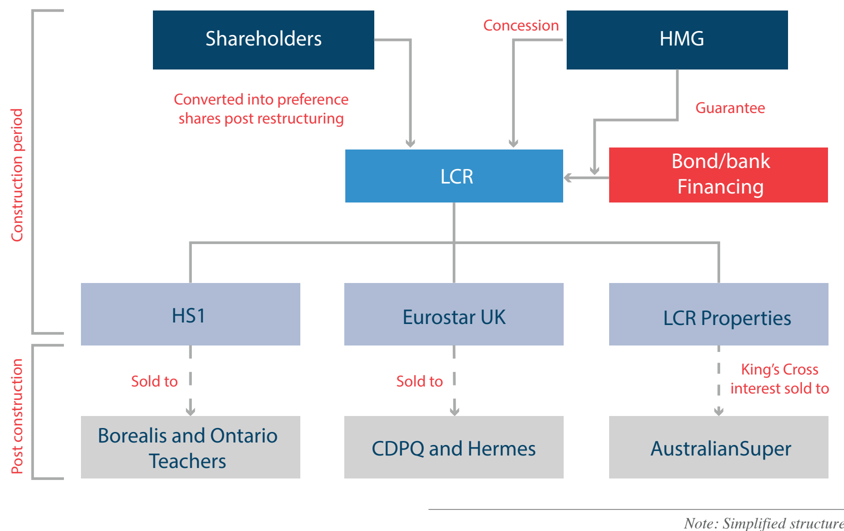
2.3.3.2 Brownfield Project: High Speed 1

The financing of the £6 billion Channel Tunnel Rail Link, today known as High Speed 1 (HS1), had to undergo several significant restructurings since the original concession in 1996. in 2010, following the successful completion of its construction phase three years earlier, the involved parties were able to successfully privatise HS1. HS1, therefore, is a good example of how an infrastructure project needs public sector support in its construction phase, but allows the public sector to monetise (part of) its investment in the (successful) operational phase.

In 1996, London & Continental Railways (LCR), a private sector consortium, won the concession to design, build, finance and operate HS1 and the UK interest in Eurostar. The original financing plan was based on a private sector equity investment and a debt bridge leading to an Initial Public Offering of LCR and long-term project finance debt.

However, this financing plan could not be realised with Eurostar passenger and yield forecasts turning out to be overly optimistic, which made it impossible to raise sufficient private sector finance. In the revised financing plan the UK Government agreed to guarantee the debt financing requirement.

Figure 22: Structure chart



Note: Simplified structure

In addition, while the private sector investors continued to be involved, the equity upside was capped and a risk transfer package put in place to incentivise each relevant contractor/operator and to share upside and downside risks. The resulting significant reduction in the cost of capital avoided the need for additional subsidies and grants from the UK government, and provided the stability and certainty for the construction project to be delivered on time and within the original target cost.

After the successful completion of HS1 and several years of operation, LCR and the UK Government reassessed the rationale for integrated ownership of rail infrastructure and train operations, and decided to restructure LCR in mid-2010. The UK Government also wanted to monetise some of its investment in HS1 by re-introducing further private sector capital and risk transfer. The Government created a new 30-year concession and regulatory framework for HS1, and decided to change the underlying economics of the HS1 system to make it commercially viable on a standalone basis. This also involved the UK government assuming most of the construction debt to enable a clean and successful privatisation without any ongoing government support of the capital structure.

In November 2010, the UK Government was able to complete within less than 5 months the sale of HS1 to international institutional investors, namely two Canadian pension funds, for a value of £2.1bn. The terms of the sale were competitive, supported by a favourable regulatory environment for infrastructure investments by pension funds in Canada. The new owners of HS1 are incentivised to ensure safe operation of the railway and grow its usage. At the end of the concession period, the asset will revert to the UK government, which will then be able to let another concession to recoup more of the original investment.

Even if not by original design, the HS1 model offers an example of how governments can support the construction phase of a project to optimise the risk transfer and reduce the cost of capital and therefore the subsidy requirement, followed by a monetisation once it has been completed and institutional investors are better placed to value the asset.

2.3.4 Lessons learned

As with the TTT project, HS1 was of exceptional scale and thus both were, to a certain extent, outliers in the infrastructure-financing world. The public sector therefore could not rely on existing standardisation, but needed to lever experience gained with other infrastructure classes for tailoring the investment case and process to the preferences of the private investors. Achieving comparability to a well-known infrastructure class with controllable risks involved, therefore, was one of the key success factors in both TTT and HS1.

Common to both projects was that in the construction phase the financing inevitably included a restricted risk transfer to the public sector, i.e. not in the form of public debt, but contingent guarantees leaving a significant share of responsibility to the private sector. Consequently, the private sector was incentivised for an in-plan completion and operation of the infrastructure asset. The remaining risk for debt investors could be placed thanks to an investment grade rating and/or risk transparency partially achieved through intensive preparation of the projects, including analysis of the risks involved.

Finally, an efficient regulatory process on the public sector side also significantly contributed to the success of both projects. Private institutional investors were attracted by mitigating risks through a fair and stable regulatory framework with clear and transparent legal procedures and efficient government coordination at all involved levels.

2.3.5 Recommendations for an enhanced regulatory framework

Improving the environment for infrastructure investments has been the subject of several studies since the start of the financial crisis. In 2013, the Group of Thirty (G30)[40] issued a report on 'Long-term Finance and Economic Growth' in which they observed that the current framework for long-term finance increasingly constrained private long-term investors in their ability to provide long-term financing. This development calls, in its view, for multifaceted policy responses inter alia by the FSB, IMF, the World Bank and the OECD in favour of long-term investments. In order to incentivise the demand side the G30 recommended more specifically:

- A review of the regulatory and accounting treatments of assets held with long-term horizons,
- measures to better differentiate between short and long-term debt, and
- consideration of a phase-out of the preferential treatment of sovereign debts.

Furthermore, the G30 advocated in favour of developing new long-term finance products such as savings programs as well as debt and equity capital markets that support long-term investments, e.g. by providing appropriate means of securitisations of long-term debt. Finally, the G30 emphasised the importance of cross-border capital flows for an international diversification of investment.

These recommendations were broadly in line with recommendations published in October 2014 by the European Financial Services Round Table (EFR).[41] The EFR defined a set of best practice recommendations intended to make infrastructure investments more accessible. Similarly, the Institute of International Finance (IIF) approved in October 2015 a set of Principles for enhancing investor rights in Long-Term Investment outlining the top ten principles to strengthen the legal and regulatory framework for the protection of investor rights with regard to infrastructure investments.[42]

The following recommendations support the above mentioned conclusions, attempting at the same time to leverage the lessons learned from the TTT and HS1 projects to develop further, more concrete ideas for a successful infrastructure financing framework in the European Union.

2.3.5.1 Encourage efficient risk-sharing

Firstly, in our view the success of an infrastructure project lies in the right balance of cooperation between both public and private sectors, considering and identifying public support measures the private sector currently needs in order to improve accessibility for infrastructure financing, e.g. through credit enhancement and guarantee programs. This cooperation is particularly important for greenfield projects, but also in the brownfield stage when the engagement of the public sector could be reduced through privatization. In this respect, a robust risk-sharing arrangement such as in the TTT and HS1 projects could serve as a model for elsewhere in Europe and could result in a well calibrated public sector engagement which leaves room to market forces and sets right incentives for the private sector.

This approach could support infrastructure investments especially since the last financial crisis has resulted in the disappearance of monoline-wrapped capital market instruments where investors were drawing comfort from debt service guarantees (wraps) to senior debt/senior bonds issued by project companies. The use of contingent guarantees, for example could be a viable and cost efficient complement to the Juncker Plan for bringing more private capital to invest in the infrastructure sector. In this respect, faster progress should be aimed for in making available 'Project Bonds' and/or schemes similar to so-called 'Loan Guarantee Instruments for Ten-T Projects' (LGTT) for large-scale infrastructure projects.[43]

2.3.5.2 Promote increased standardisation

Secondly, having comparability of different infrastructure projects to achieve risk transparency for private institutional investors is crucial, as it helps the capital market understand the economic valuation of the investment needed, both for the equity and debt component (e.g. via the use of credit rating assessment, clear regulatory framework for the specific business, and reference vending financing). We believe that this could be achieved with the following steps:

- Create a new standardised asset class by:
  a. Fostering assignment of credit rating;
  b. Defining a performance benchmark;
  c. Further aligning national legal and operational requirements.
- Harmonize financing documentation (for loans and bonds) – as highlighted already by the EFR and the IIF – by:
  a. Creating regular standardised reporting, and developing documentation and disclosure based transparency on best-practice framework;
  b. Using covenants and accelerated due diligence processes;
  c. Creating elements to strengthen investors' rights.

2.3.5.3 Enhance comparability and transparency

Transparency is also a major driver for our third recommendation. By establishing and making accessible national/regional/local infrastructure pipelines, information asymmetry could be avoided and better alignment of interest among the different players in the financing markets could be promoted. The possibility to benchmark one infrastructure project against another requires the existence of other projects or the predictability of upcoming projects as well as transparency of

their respective risk structures. As the EFR puts it, a pipeline would 'improve public sector confidence in PPPs and provide a road-map to commercially viable and successful projects'. The success of both TTT and HS1 was also due to the UK Government providing a clear definition about the scope and future of the infrastructure project.

Broadening information on national/regional/local pipelines by expanding the spectrum of available investment opportunities in terms of risk and return profile is crucial to increase the attractiveness of infrastructure among a higher number of potential institutional investors. Demand for infrastructure assets among institutional investors differs in terms of return expectation, risk profile, tenor, etc. So far, only a limited number of institutions have looked at opportunities in this asset class; a broadening of the project pipelines would raise interest and ultimately increase demand.

2.3.5.4 Address further legislative and regulatory burdens

Whereas the European Commission has recently proposed changes to the Solvency II regulation addressing unintended disincentives caused by specific capital charges, (national) regulations will continue to have to classify infrastructure debts – as they are regularly in the form of loans rather than bonds - as illiquid assets rather than as fixed income assets. This limits significantly the possibility for institutional investors to invest in infrastructure. This could be addressed by classifying all infrastructure debt as an asset class that is distinct from both traditional liquid asset classes such as listed stock and bonds (demanding lower capital charges), and alternative illiquid asset classes such as private equity or infrastructure equity (demanding higher capital charges). With regard to their strategic asset allocation, this is in fact already common practice among institutional investors where three distinct asset classes are considered: liquid, semi-liquid and illiquid.

Infrastructure debt could well be included, in consideration of its lower risk profile in terms of historical default rates (compared for instance to liquid high-yield bonds), in such a semi-liquid class which would contribute significantly to the attractiveness of these assets among institutional investors for their long-oriented portfolio tranches which can be invested into less liquid assets.

2.3.5.5 Create public competence centres and strive further towards efficient procurement processes

Both TTT and HS1 also showed that a continuous involvement of well-informed public authorities based on transparent and fair processes – for which the UK is well known in the infrastructure field - was an essential success factor. It ensured not only an effective and efficient promotion of value for money towards the private sector, but also an appropriate protection of public interests.
In order to apply this idea across Europe we see benefits in centralising the procurement process within a Member State's government to share lessons learned and investment in leading talent.

2.3.5.6 A transparent and reliable framework for dispute resolution

The SFC concurs with the IIF which has highlighted the importance of a robust framework for dispute resolution. As disputes may occasionally arise in connection with infrastructure investments, procedures should be established to resolve disputes in a transparent and reliable manner. International settlement mechanisms such as the World Bank's International Centre for Settlement of Investment Disputes or the London Court of International Arbitration may be relevant, and in Europe the European Court of Human Rights should prove, over time, as an important tool to enhance confidence and stability as a precondition for long-term investment.[44]

3 Conclusions: how international investment can help make the Capital Markets Union a success

The SFC strongly supports the Commission's ambition to strengthen economic activity and job creation in Europe and is convinced that a Capital Markets Union (CMU) can complement a strong banking sector in the financing of the economy. In the first chapter we explored the significant contribution investment from countries outside of the EU can make to this ambition and to the economy in general. As Lord Hill, the European Commissioner responsible for the CMU initiative said to an audience in Hong Kong last September, "We want a Europe that is open for business and open to investment." The SFC very much shares this goal, and has submitted contributions to the Green Paper consultation on the CMU and the Commission's Call for Evidence, with practical suggestions on how to achieve this.

RECOMMENDATIONS AT A GLANCE

Corporate investment
- Reducing red tape within member economies by promoting best practices
- Enhancing SME access to finance by promoting CMU and BU implementation and completion
- 'Think Small First' to foster overall conditions favourable to SME investments

Private investment
- Reviewing the retail client classification in MiFID
- Making targeted adjustments to tax systems
- Driving convergence in the interpretation of the AIFMD passport among EU Member States
- Making a pan-European marketing passport available to non-EU AIFMs
- Stimulating the development of EU private equity investment funds

Institutional investment
- Encouraging efficient risk-sharing
- Promoting increased standardisation
- Enhancing comparability and transparency
- Addressing further legislative and regulatory burdens
- Creating public competence centres and strive further towards efficient procurement processes
- Ensuring a transparent and reliable framework for dispute resolution

Enhancing the international dimension in EU policy-making
- Pursuing an enhanced approach to equivalence determinations
- Communicating the EU's openness to investment from the outside world
- Championing international standards
- Establishing formal regulatory dialogues with relevant third country authorities

3.1 Attracting international investment

Drawing on the evidence found in our case studies in the second chapter, we considered what concrete steps the EU could reasonably take to facilitate investment from international corporates, institutional investors, and private wealth. Increasing investment from these sources outside the EU will contribute to job creation and economic growth, and help make the CMU project a success.

3.1.1 Corporate investment

Our first case study highlighted the contribution made by Switzerland to the EU stock of inward investment. Between them, Swiss firms provide the second highest amount of foreign direct investment after the US. We surveyed 146 internationally orientated Swiss SMEs, a fifth of whom intend to make overseas investments during the course of 2016. Reflecting the close trading and cultural links between Switzerland and the EU, two thirds of the planned investments will be in the EU.

Almost half, 43%, of the businesses, we surveyed cited red tape as the biggest obstacle to the EU's attractiveness as a destination for foreign investment, and only a third of them intended to increase their levels of investment in the current year. The vast majority finance their investments with their own cash, and just a fifth avail themselves of bank loans; just 2% source their financial needs on the capital market, yet 20% would like to see a common EU capital market. Asked what the biggest hurdles to financing via capital markets were, 31% said legal cost, and 29% higher capital costs. A successful CMU would therefore appear to be highly appreciated by Swiss firms, the second biggest providers of the EU's inward FDI.

3.1.2 Private investment

In our second case study, we showed that private investment is a hugely important source of funding, particularly for SMEs in sectors that are less likely to attract more traditional sources of financing. Private equity backs over 25,000 companies in the EU, 83% of which are SMEs in sectors such as life sciences, energy and retail. Nevertheless, while investment in private equity in Europe is growing, the market is still small in comparison to the US where over the past 10 years US firms managed to raise almost $2 trillion, compared with $641 billion raised in Europe. This is despite, for instance, European UHNWI controlling 900 billion dollars more in net assets than their US counterparts do.

We concluded that cultural differences in the approach to investment, as well as the differences in the overall investment framework for alternative investments between the US and Europe provided some explanation for the substantial differences in size and development of the respective markets. However, there are a number of EU policy measures that should be adjusted to encourage investments in private equity. These include better regulation, non-discriminating taxation systems, enhancements in the registration and distribution of alternative investment products, and measures to allow economies of scale.

3.1.3 Institutional investment

Examining two large-scale infrastructure investment projects in the UK, we found, in our last case study, that while public sector involvement was essential in the construction phase, well-calibrated arrangements for co-operation between the public and private sectors underpinned by a fair and stable regulatory framework was the key to success. This was particularly the case for 'greenfield' projects where the public sector needed to lever experience gained with other infrastructure classes for tailoring the investment case and process to the preferences of the private investors.

We found that risk-sharing by the public sector through contingent guarantees, rather than in the form of public debt, contributed to attract private capital while still leaving a

significant share of responsibility with the private sector. Consequently, the private sector was incentivised for an in-plan completion and operation of the infrastructure asset. Further measures to strengthen infrastructure investments include promoting increased standardisation, enhancing comparability and transparency, addressing further legislative and regulatory burdens, and creating public competence centres and efficient procurement processes.

3.2 Enhancing the international dimension in EU policy-making

Reforming the regulatory regime in these areas will help enhance the EU's ability to attract investment from beyond its borders, and complement the measures already being taken to complete the Capital Market Union and improve the EU's regulatory framework based on the feedback to the Commission's Call for Evidence exercise. Combined with Vice President Timmermans' Better Regulation agenda, both of these initiatives have the potential to make a considerable contribution to the functioning of EU capital markets and the ability of the financial services industry to contribute to growth and jobs. However, the impact could be greater still if there were an increased emphasis on the international dimension.

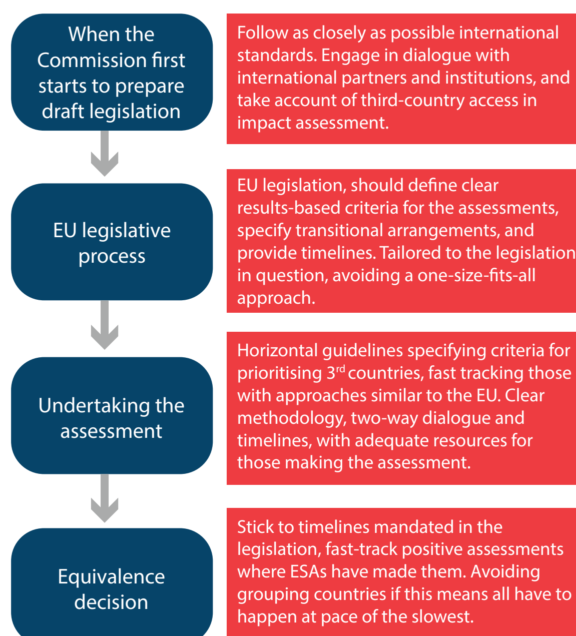
In its February 2015 Green Paper on Capital Market Union, the Commission noted that *"European capital markets must be open and globally competitive, well-regulated and integrated to attract foreign investment..."* and further, *"given the global nature of capital markets, it is important that the Capital Markets Union is developed taking into account the wider global context."* However, by the time the Action Plan itself was published last September, the international dimension had a less prominent role. Similarly, improving market access and investment from outside the EU was not a specific theme in the Call for Evidence exercise.

To complement the specific recommendations identified in our case studies outlined above, we believe additional measures should be taken as part of the Call for Evidence and CMU follow-up.

3.2.1 Pursuing an enhanced approach to equivalence determinations for third countries

Equivalence assessments are a tool for providing international companies regulated to the same high standards as those in the EU with access to the EU market. A positive equivalence assessment of a third country's regulatory regime provides for legal certainty, confirms that the third country legal framework manages risk in the financial system, delivers consistent investor protection and market integrity, and checks that the third country regime ensures effective oversight and enforcement.

Figure 23: Stage by stage: An enhanced approach to equivalence



Equivalence thus ensures regulatory standards are not undermined, and facilitates market access, which in turn allows for deeper and more efficient capital flows, increased access to capital for businesses and consumers, diversified investor choice and enhanced competition. Correspondingly, in the absence of an effective framework for equivalence assessment, EU businesses and consumers are shut-off from service providers and investment opportunities from abroad.

The SFC suggests that as part of the CMU project, the EU should establish an enhanced process for making equivalence determination, as highlighted in Figure 23. This should be based on identifying best practice to be applied at each stage of the process; right through from when the Commission consults on the initial legislation to the final decision. The idea is to strike a balance between a common transparent approach to equivalence assessments, while avoiding a one size-fits-all method, with insufficient flexibility to adapt the process to a range of forthcoming legislation. Finally, to address possible equivalence assessment delays, EU legislation should always include appropriate transitional provisions to provide market participants with the required legal certainty and predictability and prevent possible disruption to EU market access.

3.2.2 Communicating the EU's openness to investment from the outside world

Alongside specific reforms to the regulatory framework to facilitate investment from the rest of the world and a new approach to equivalence, we believe the EU could do more to signal its openness to investment by communicating better with the rest of the world. While important steps are being taken, e.g. by the EU's expressed desire to include financial services in TTIP and the Commission's engagement with the US more generally, we are concerned that the cumulative impact of a number of recent measures sends out the wrong signal to international investors and policymakers.

The recent decision by the Council to exclude third-country originated securitisations from the new Simple, Transparent, and Standardised regime is particularly egregious, especially so as it is the first proposal resulting from the CMU initiative. This comes in addition to the limitations on third country investors we have already noted in respect of MiFID, AIFMD, and ELTIFs.

Once these reforms have been undertaken, the EU could do more to market itself as 'open for business' abroad, and overcome perceptions that EU markets are difficult to access.

3.2.3 Championing consistent international standards

At the same time, the EU should continue and step-up its engagement in international fora promoting globally consistent standards.

Given the urgent need to enhance the quality of regulation in the wake of the financial crisis, and the unfeasibility of defining and enforcing detailed regulatory standards at a global level, the original intention of the G20 was to agree coherent priorities and principles, which would then be put into practice at national and, in the EU's case, regional levels.

However, domestic considerations came to dominate in the implementation, and in large jurisdictions like the US and the EU, time-scales and approaches diverged. New regulations, such as that concerning the treatment of CCPs in EMIR and Dodd-Frank, were often drawn up in isolation, and incompatible approaches to the third country dimension emerged.

The resulting regulatory fragmentation has gone against the original intentions of the G20, and contributed to a reduction in capital flows around the world. The EU should take the lead in trying to reverse this trend, advocating for globally consistent standards abroad. At the same time, the EU should be leading by example at home through consistent implementation both within the Banking Union and between the Banking Union and the rest of the EU.

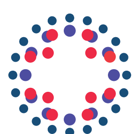
3.2.4 Establishing formal regulatory dialogues with relevant third country authorities

The European Parliament has stressed 'the need for international regulatory cooperation in a global framework with improved cooperation and increased accountability.'[45]

To avoid divergences in approach, and facilitate a better understanding of regulatory and supervisory approaches, the SFC calls on the Commission and ESAs to establish formal and regular dialogues with third country authorities. These should be co-operative discussions based on finding mutually beneficial and common solutions to shared problems, thus enabling public authorities to tackle problems and promote financial stability while preserving the flow of capital for investment. Many of the problems making equivalence determination difficult stem from divergences of approach that could be avoided by more discussion taking place between jurisdictions before regulations are drafted and implemented.

Endnotes

[1] See "The Global Competitiveness Report 2014-2015", World Economic Forum 2014
[2] See "Global Opportunity index. Attracting Foreign Investment, Milken Institute, Second Edition, June 2015
[3] Sub-components: Macroperformance; Openness to trade and FDI; Quality and structure of the labour force; Physical infrastructure.
[4] Accounting and disclosure requirements; costs of terrorism and crime; tax burden; costs of starting a business, enforcing contracts, resolving insolvency.
[5] Extent and burden of regulation; corruption; transparency; extent of controls on capital.
[6] Legal infrastructure; protection of property right and investor rights.
[7] See "Doing Business 2016. Measuring Regulatory Quality and Efficiency"; The World Bank 2015
[8] 1. Starting a business; 2. Dealing with construction permits; 3. Getting electricity; 4. Registering property; 5. Getting credit; 6. Protecting minority investors; 7. Paying taxes; 8. Trading across borders; 9. Enforcing contracts; 10. Resolving insolvency.
[9] Transparency International: Corruption Perceptions Index 2015: Corruption still rife but 2015 saw pockets of hope. http://www.transparency.org/news/pressrelease/corruption_perceptions_index_2015_corruption_still_rife_but_2015_saw_pocket
[10] EY's attractiveness survey: Europe 2015. Comeback time
[11] The financial market development index consists of eight sub-components: 1. Availability of financial services; 2. Affordability of financial services; 3. Financing through local equity market; 4. Ease of access to loans; 5. Venture capital availability; 6. Soundness of banks; 7. Regulation of securities exchanges; 8. Legal protection of borrows and lender.
[12] See our report "The EU & its Partners: Defending Open Markets in Challenging Times"; Swiss Finance Council 2015
[13] See, for example: "Increasing investment in Germany, Report prepared by the Expert Commission on behalf of the Federal Minister of Economic Affairs and Energy, April 2015.
[14] "Is it time for an infrastructure push? The Macroeconomic effects of public investment"; IMF, World Economic Outlook October 2014, p. 75-114.
[15] Another measure is trade. See the preceding study: The EU & its Partners: Defending Open Markets in Challenging Times; Swiss Finance Council 2015
[16] In order to examine the FDI behavior of Swiss SMEs, Switzerland Global Enterprise and Credit Suisse undertook a survey among about 2000 internationally oriented SMEs in Switzerland. A total of a 146 SMEs of all major industries and regions in Switzerland responded to the survey conducted between December 7 and December 23, 2015. In Switzerland 99.7% of all firms are SMEs and they employ 66.6% of all employees. In the EU, 99.8% of businesses are SMEs and at 67.4% they account for an important share of employment too.
[17] Capgemini, World Wealth Report 2015.
[18] Common investments strategies in private equity include leveraged buyouts, venture capital, growth capital, distressed investments and mezzanine capital.
[19] EVCA, "European Private Equity Activity Report 2014".
[20] Capgemini, World Wealth Report 2015.
[21] Capgemini, World Wealth Report 2015.
[22] Knight Frank, The Wealth Report, 2015.
[23] CNBC, Private equity "Asias's wealthy choose to partner, not invest in, private equity", 3 March 2014
[24] Capgemini, World Wealth Report 2015.
[25] Private equity industry activity can be broken down into fundraising, investment and divestment. The focus in this paper is put on private equity investment activity.
[26] EVCA, "European Private Equity Activity Report 2014".
[27] BCG and IESE study: "A rise in good deals, but an investor drought – The state of European Venture Capital", October 2015.
[28] A portfolio company is a company in which a private equity firm invests in. The portfolio company is thereby a part of the total holdings of a private equity fund.
[29] EVCA, "European Private Equity Activity Report 2014".
[30] BCG and IESE study: "A rise in good deals, but an investor drought – The state of European Venture Capital", October 2015.
[31] BCG and IESE study: "A rise in good deals, but an investor drought – The state of European Venture Capital", October 2015.
[32] UBS white paper "The investment drought: How can the problem of weak investment be fixed?", September 2015, Issue 1.
[33] BCG and IESE study: "A rise in good deals, but an investor drought – The state of European Venture Capital", October 2015.
[34] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A8-2015-0360+0+DOC+PDF+V0//EN, page 12
[35] UBS, The investment drought, p. 12
[36] "The investment drought: How can the problem of weak investment be fixed", UBS White Paper, 1 September 2015, Issue 1.
[37] EU Directive 2009/138/EC (Solvency II) and its implementing rules in the Delegated Regulation (EU) 2015/35 of 10 October 2014 setting out inter alia parameters of the standard formula to calculate the Solvency Capital Requirement, including the specific calibrations for risk factors to be applied on different types of insurers' investments; these rules have been fully applicable since 1 January 2016.
[38] In many disciplines, including in finance, a greenfield project is one that lacks constraints imposed by prior work.
[39] The IRR is frequently used by corporations to calculate a rate of return on an investment, i.e. to measure and compare the profitability of investments based on an interest rate that will bring a series of cash flows (positive and negative) to a net present value (NPV) of zero.
[40] See http://group30.org/
[41] "Facilitating European Infrastructure Investment", European Financial Services Round Table, October 2014.
[42] See http://www.iif.com
[43] LGTT is an innovative financial instrument set up and developed jointly by the European Commission and the European Investment Bank, see http://www.eib.org/about/documents/lgtt-fact-sheet.htm?lang=en
[44] See " Principles to enhance the protection of investor rights in Long-Term Infrastructure Investment"; IIF, October 2015
[45] Balz report on stocktaking and challenges of the EU Financial Services Regulation: impact and the way forward towards a more efficient and effective EU framework for Financial Regulation and a Capital Markets Union (2015/2106(INI))



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