

IFSC Stakeholder Breakfast

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Comparative Benchmarking: Opportunities for an African IFSC

Keith Jefferis

Themes

- What can we learn from the experiences of other IFSCs?
- Is there an opportunity for an African IFSC?
- How well does Botswana fit the bill, and what more might need to be done?

International IFSCs/OFCs

Different countries use different names for their IFSC-type entities, but the commonly-used generic term is an Offshore Financial Centre, or OFC. While there are different names, a common theme is shared, that of providing financial services for entities based outside of their national economies, i.e. offshore services.

Within the broad spectrum of OFCs, a wide range of services is offered, and different OFCs specialise in different functions. These services may be narrow, focusing on offshore banking, or broad,

focusing on a wide range of financial services (e.g. going beyond banking to include other financial services, such as insurance and fund management, and administration and back office services to financial firms), or even to business services more generally, such as Business Processing Outsourcing (BPO), call centres etc.

There are wide variations in the structure and types of operations of OFCs. Some e.g. British Virgin Islands (BVI), Cayman Islands and other locations in the Caribbean specialise in hosting “brass plate” operations, where the focus is on providing a favourable location for companies to set up a legal jurisdiction and to channel revenues, but there is no real pretence at inducing those companies to have a substantive presence or conduct substantive operations; OFC host countries earn revenues primarily from company and financial administration fees, and perhaps from taxes. These are the classic tax havens, with low or zero taxes. Monitoring the activities of thousands of non-resident companies is very difficult, and they are of course highly vulnerable to reputational risk through being used for money laundering etc. (indeed, one of the factors that attracts companies to some OFCs is lack of transparency regarding the ownership of registered companies, which may encourage money laundering).

Other OFCs require some kind of physical presence of the companies legally operating there - both to maximise benefits to the local economy and to enable more substantive oversight of what those companies are doing.

There are several defining characteristics of typical OFC entities:

- they serve primarily or exclusively non-resident clients on both sides of their balance sheets (e.g. banks raising funds and lending offshore);
- transactions are initiated outside of the host country;
- they operate in currencies other than the national currency of the host country;
- they are typically owned by non-residents.

OFCs are typically located in small economies. Examples include Jersey, Luxembourg, Dublin, Singapore, Bahrain, Dubai, various Caribbean islands, and Mauritius.

Most OFCs notably they are located where they can easily serve nearby large, and preferably fast-growing, markets. OFCs need to have specific connections with those large, fast growing markets - these connections may be cultural/historic (e.g. Jersey/London, Dublin/London), or geographical (Caribbean/US), or specifically nurtured on the basis of a set of product and service offerings that meet specific needs of the metropolitan market. Very often those offerings provide ways of avoiding or circumventing regulations or restrictions in the metropolitan economy. Successful OFCs can however outgrow their original client base and develop to provide worldwide services.

Besides links with a larger market that they can service, OFCs have other specific characteristics:

- low uniform tax rates or a special, segregated low tax rate for offshore business;

- OFCs require limited and flexible regulation, and perhaps special regulation for specific activities;
- no exchange controls (at least not for OFC businesses)
- access to suitably skilled/qualified labour, and increasingly, they require access to high speed/high capacity data links. Needless to say, all of the above, along with office premises and other support services, must be provided at internationally competitive prices.

Is there an opportunity for an African OFC?

The answer to this is almost certainly yes. The South African economy, by far the largest in Africa, is growing fast, as indeed are many other countries in SSA. While there has been limited success in attracting the levels of FDI that Africa would like, and African countries generally do badly in terms of international assessments such as the World Bank's "Doing Business" survey, reforms are rapidly taking place, and there is no doubt that the continent is increasingly "open for business". With 6.3% growth forecast by the IMF for 2007, sub-Saharan Africa is set to be one of the fastest growing regions of the world.

One of the results of this is that there are many firms doing business in a number of African economies (one of the consequences of Africa comprising a large number of small economies, rather than fewer large ones, as in other continents). Many of these companies are South African, although by no means all of them are.

The growth of trade and cross-border investment flows provides a number of opportunities for one or more African OFCs.

One opportunity is to provide a legal domicile for offshore operations, and a convenient location for channelling financial flows generated across a range of countries. This can simply be companies registered outside of their primary country of operation for tax or other reasons, such as escaping from burdensome exchange controls. There is also scope for providing a legal domicile for regional head offices and holding companies.

In SADC, Mauritius has a well established OFC, dating back to the early 1980s, which had 20,000 offshore companies registered in 2004. Besides having a "first mover advantage", Mauritius also has a large and well developed support structure in terms of legal, financial and administrative services, as well as a modern and flexible regulatory structure, and low cost telecommunications. Mauritius developed by taking advantage of its position in Southern Africa - many of the companies registered there are South African by origin and ownership - and also its historical role as a link between Africa and Asia, and in particular its links to India, which yielded many potential opportunities given India's highly regulated economy.

How important is location, however? It may not matter very much when attention is on legal domicile rather than physical presence. But if physical operations (rather than just support services) are carried out, then physical proximity to South Africa is useful, as SA is the centre for economic activity in the region. In relation to South Africa, Mauritius is not well located as it is remote and

expensive to get to. There may be potential for a better-located OFC to provide services to companies investing in sub-Saharan Africa, whether from SA or RoW.

Note that the presence of a developed financial sector in Johannesburg is not a threat to the development of an OFC in Botswana; indeed it is an opportunity - in the same way that Jersey, Dublin and Luxembourg developed serving the City of London, but providing very specialised OFC functions, e.g. offshore fund management, not the general financial services that London itself provided. International experience shows that large onshore financial centres and smaller OFCs are complementary.

Opportunities for a Botswana OFC/IFSC

Mauritius is probably Botswana's main competition, but Botswana should develop following a somewhat different route - attracting companies with a physical presence, not just providing administrative support to brass plate operations. It should aim for fewer, larger operations, with direct job creation in the businesses themselves, not just in administering them. Nevertheless there are many opportunities, in financially specific activities - e.g. fund registration and management, international insurance services, bank holding companies. There may also be new opportunities related to the expansion of diamond processing, e.g. financial services specific to the international diamond industry.

However, Botswana should not be concerned with just attracting offshore financial services. In general, Botswana should cast its net widely, looking at service activities in general. This has started; many of the companies already in the IFSC are non-financial

companies in the sense that their primary business is not of a financial nature, although they may use the Botswana IFSC for channelling financial flows. One of the main potential markets, that of regional head offices and holding companies, is not primarily a financial market. The broad approach is also reflected in the IFSC's efforts to attract BPO activities and other service operations such as call centres.

If this broad strategy is to be followed, this means that Botswana has to offer multi-faceted attractions. It has to be an OFC, offering attributes that offshore financial services companies will find attractive, but in addition has to go beyond this and offer the attributes necessary to attract internationally mobile service activities. This market is, of course, highly competitive, and success requires the necessary competitiveness.

Another area that Botswana should consider exploiting is its ready availability of capital. This is a distinct comparative advantage that Botswana has and many other countries do not. Botswana has an exceptionally high savings rate - over 40% of GDP according to the national accounts - which is reflected, inter alia, in the accumulation of significant excess liquidity in the domestic financial market, as well as substantial capital outflows.

This means that Botswana could potentially be used a venue for capital raising by offshore entities. For instance, Botswana has a small but growing number of mining companies registered on the BSE, usually of companies with operations in Botswana, dual listed stocks with their primary listing in Australia or Canada, where their main capital raising takes place. But why can't Botswana develop

as a primary location for listing and capital-raising, and not just for mining ventures in Botswana but for mining ventures elsewhere in Africa, or indeed elsewhere in the world. There is a niche market here that can be exploited on the basis of two of Botswana's comparative advantages, its mining sector and plentiful capital. This would have knock-on effects, such as developing the BSE as a specialised market for raising mining finance and risk capital in Africa; it would provide new investment opportunities for the holders of savings, notably the pension fund managers, and could also help to reduce excess liquidity and the costs of its absorption. It would also encourage other activities such as mining finance advisers and the associated research and broking activities.

What needs to be done for these opportunities to be exploited? There are number of essential prerequisites, including telecoms services, skills, and appropriate regulation.

First, low cost and high capacity telecoms links are essential, as almost all of the activities being considered are data-intensive. While Botswana has some distance to go - at present telecoms are expensive and capacity is limited - the current liberalisation programme, the intention to privatise BTC, and the EASSY submarine cable should help to resolve this in the near future. But government may need to take a lead in supporting investment in telecoms capacity in a few strategic locations (e.g. the Mauritius Cyber City) - government investment in strategic telecoms links would most likely pay far greater economic dividends than some of the money being spent on little-used roads to remote locations.

Labour skills - this is one of Botswana's advantages, or potential advantages. The level of secondary education is high, and school leavers increasingly have basic IT awareness. There is probably room for school curricula to be tailored more to employers' needs, but the main drawback at present is probably cost - comparative studies have shown that salaries for basic financial, IT and administrative personnel are very high in Botswana by regional and international standards - specifically in the locations that Botswana is competing with - and efforts need to be made to align wages to international levels. Certainly, initial salary expectations from school and university graduates are unrealistically high, given the level of unemployment.

Regulation. One of the most important areas to get right is regulation. Here there a number of issues to consider, but broadly the guiding principles should be that regulation must be light, flexible, not unduly slow or intrusive in its implementation, and should not attempt to draw a strict dividing line between domestic and offshore activities.

Regulation does of course have to satisfy multiple objectives. It has to offer certain protections, including providing a level of assurance that assets will not be unduly at risk, that the domestic financial system is protected, that money laundering will be countered and the country's reputation protected. In this, there are international standards to be met. At the same time, regulation should not be unduly restrictive or intrusive, especially when competing in the OFC space - one of the main attractions and reasons for firms using OFCs is that regulation is light compared to their home jurisdictions. Regulation in an OFC does

not have to be the same as in larger centres - e.g., regulation in Jersey, Dublin and Luxembourg is much lighter than in London - which is in turn lighter than in New York.

A second point about regulation is that it has to be flexible. An attempt to write rules covering all current activities will soon be found wanting when an innovative activity comes along, and it is these types of innovative activities that an emerging OFC wishes to attract. Hence regulation should be based more on principles than on rules, and should be flexible enough to accommodate a new activity quickly.

A third point is that regulation is primarily applicable to finance-related activities, while many of the activities that the IFSC has been attracting and still wishes to attract are non-financial. Such activities should be subject to extremely light regulation, which should essentially be restricted to preventing criminal activities.

A fourth point is that if part of the IFSC's objective is to develop Botswana as a centre for capital raising activities, whether in the mining sector or elsewhere, the sharp distinction between domestic and offshore activities is not appropriate. By definition, such activities use domestic savings to finance offshore activities, and attempts to draw a sharp line between domestic and offshore activities will make it difficult, if not impossible to exploit this potential activity. Concerns that this will lead to an outflow of savings are misplaced - the savings are already flowing out of the country in one form or another, and must do to maintain basic macroeconomic balance - and these concerns should not be allowed to influence policy.

All of this suggests that there are two key requirements for the IFSC to be successful: (i) the current basis for the IFSC - a favourable offshore tax regime - is not in itself sufficient; supporting products and services, competitively priced, are essential; (ii) the regulatory structure needs to be reformed, to be more flexible and accommodating to a wide range of activities. A World Bank report produced in 2004 as part of a broader export diversification study pointed to many areas where the regulatory structure was not supportive of expanding IFSC activities. Reports of companies facing very long approval processes, and of the regulatory structure being found wanting when "new" activities emerge, do not suggest that the regulatory approach is correct at present, although there are reports that things have improved over the past two years. The proposed consolidation of non-bank regulation into a new regulatory authority is a step in the right direction, as long as it does not lead to more bureaucracy. However, the banking legislation may also need to be reviewed, as it pre-dates the IFSC, and would benefit from being more flexible in accommodating the type of banking activities that the IFSC is targeting. Finally, the tax authorities also need to be more accommodating, and there may be merit in considering a review of the tax regime and introducing an across the board low tax rate, rather than a special rate for IFSC activities, which would obviate tax department concerns that the IFSC is leading to leakage of tax payments by domestic companies.

In conclusion - offshore financial services, and international services offers important opportunities for Botswana. Trade in services globally is growing faster than trade in goods, and for

Botswana, some of the impediments to trade in manufactured goods - lack of raw materials, distance from ports and expensive transport connections - do not apply to services. The education system also seems to be more geared to services type work than manufacturing. But if this route is to be followed, certain attributes need to be developed, as noted above. Botswana also needs to develop its negotiating capacity with regard to international services trade agreements, which are distinct from those relating to goods.