The role of international financial centres in delivering growth in developing countries

Key points

- International financial centres (IFCs) play an important role in assisting less developed countries with little capital to access the investment funds that they need, thereby promoting greater investment, economic growth, and job creation
- Major global organisations, such as the World Bank and the European Bank for Reconstruction & Development, use companies incorporated in IFCs to fund investments
- Headline-grabbing numbers by campaigners that suggest that IFCs hamper development in poor countries do not bear scrutiny

1. International financial centres help developing countries access stronger institutions that help development

Many less developed countries – including those in Africa, South East Asia, and Latin America – have the potential to grow rapidly, but require capital investment to do so. To grow their economies at 5% per year – and thus quadruple in size by 2040 – Africa alone will need over $10 trillion of capital above and beyond its current level of investment. Domestic capital markets, including both private and public sectors, can meet just a fraction of this demand, so external sources of capital are required to meet the goals of less developed countries and lift their inhabitants out of poverty.

The ability of the local private sector to accumulate capital is hindered by poor institutions and governance in less developed countries. Varying levels of protection of the rule of law, as measured by the World Justice Project Rule of Law Index, explain two-thirds of the difference between countries' gross domestic products per capita; income increases exponentially in countries with more constraints on arbitrary government power, less corruption, and more reliable legal institutions.

Foreign investors are likely to be further dissuaded from investing in many developing countries by the difficulty of conducting business there. According to a global ranking of countries by the World Bank, the majority of African countries, for example, fall in the bottom fifth of all nations globally on a scale of ease of doing business. Investment is also often hindered by corruption. Economic crime is a major problem for the developing world; between US$1.5 trillion and US$2.0 trillion a year is believed to be paid in bribes: equivalent to roughly 2% of global gross domestic product.[1]

IFCs can be a catalyst for economic growth by overcoming these institutional failings and offering better institutions and governance, an easier business environment in which to do business, and freedom from corruption. They do this by providing:

[1] International Monetary Fund, *Corruption: Costs and Mitigating Strategies* (IMF, Washington D.C) May 2016.

- **Reliable legal institutions**, with legal systems based on English law, judges and lawyers usually trained in and dual-qualified in England, but highly-specialised in financial services.

- **Independent law-making**, geared towards reducing administrative friction and delivering commercial certainty.

- **Specialised corporate law** that attract clusters of globally-used corporate vehicles and structures and are thus understood by institutional investors globally, especially those doing business with and in less developed countries.

- **Exemplary regulatory standards** and track records for tackling economic crime, so investors and investees can be assured that their money is handled safely and securely.

2. International financial centres deepen international capital markets

As well as offering the institutions that facilitate investment into less developed countries, IFCs deepen capital markets by reducing the cost of diversifying investments internationally.

Institutional investors aim to maximise risk-adjusted returns, which means the earnings from their capital after accounting for the risk of losing capital. To increase risk-adjusted returns, investors both seek higher returns – which can often be found in less developed countries – and lower risks. To avoid systemic risks – such as an economic crash or an increase in the price of a given commodity – investors want to diversify investments across market segments and geographic location.

Diversifying investments across national boundaries can be costly, with greatly differing laws on taxation, corporate governance, and securities. IFCs provide a single venue for the pooling of capital from many different locations and then the investment of that capital into many different locations. Using a hub, like an IFC, reduces the administrative burden and takes advantage of the regulatory environment and legal institutions offered there. By virtue of being tax-neutral – that is, not imposing an additional layer of tax for the privilege of pooling capital there – IFCs can do this at low cost.

As a consequence, IFCs increase investors' ability to diversify their investments, which increases cross-border investment. In particular, they increase investment into countries with less congruent legal or tax systems: which tend to be less developed countries.

Extractive industry activities provide a good example of the role that IFCs play in facilitating large-scale foreign investment into developing nations. The activities of mining companies are often risky, hugely capital intensive, and require significant initial investments. As such, mining companies need access to capital markets to raise the required funds, which are often sourced from a range of different markets around the world. IFCs offer assurances so that countries with little capital are able to borrow to finance investment in their local economies, thereby promoting economic growth.

3. Major development finance institutions use companies incorporated in international financial centres as a tool to fund investments

IFCs efficiency as investment conduits means they are widely-used by global institutions to provide development assistance. Companies incorporated in IFCs are used by major multilateral development finance institutions, including the World Bank's International Finance Corporation and the European Bank for Reconstruction & Development (EBRD), to help fund projects around the world.

We look at the use of BVI Business Companies as an example. The World Bank and EBRD have both used BVI Business Companies to help facilitate investment projects from Latin America to Asia, ranging in value from US$7.5 million to US$550 million. These are major financial institutions helping to develop, transform, and grow low-income countries; funded, and directed by the world's major governments; and choosing to use BVI Business Companies (see Figure 1).

Figure 1: Examples of investments by development banks through BVI vehicles

	Institution/ Bank	Project Name	Country	Year	Amount	Short description	Status
1	EBRD	Project Bluebird	Russia	2013	$550 million	Borets International Ltd, a holding company registered in BVI	Disbursing
2	EBRD	Chirag Early Oil	Azerbaijan	1998	$100 million	Loan to five companies including LUKoil Overseas BVI Limited.	Completed
3	IFC	Sphinx Fund	Egypt	2008	$17million investment into a $100 million fund	Sphinx Fund to be managed by Sphinx Capital Corp, a BVI company.	Active
4	IFC	Daewoo Intercity	Pakistan	2013	$20.01 million	Daewoo Pakistan Express Bus Service Ltd owned by a firm owned by Greentown Holdings BVI.	Pending disbursement
5	IFC	All Asia Growth Ventures	Philippines	1995	Lowest of $7.5 million or 15% of the fund amount	All-Asia Capital and Trust Corporation (AACTC) established a fund as an offshore venture capital company in BVI for foreign investors.	Completed
6	IFC	Kappa	Colombia	2007	$20 million debt facility	Kappa Energy Colombia Ltd is a subsidiary of Kappa Energy Holdings (BVI).	-
7	IFC	Favorita Fruit Company Ltd	Ecuador	1999	$15 million	Favorita Fruit Company Ltd is a British Virgin Islands holding company of the Wong Group.	-
8	IFC	Promasidor Nigeria Limited	Nigeria	2016	$25 million	Loan to finance expansion of food processing company which is a subsidiary of Promasidor Holdings Limited BVI.	Pending disbursement
9	IFC	Canvest Waste-to-Energy	China	2016	$104 million	The major shareholders of Canvest include Best Approach (BVI) which has a 65.1% share.	Active
10	IFC	ESIP Souq	MENA Region	2015	$30 million	Investment to aid Souq Group Ltd. (BVI) – the largest e-commerce website in the Middle East – expand into emerging markets.	Active
11	IFC	MHV II	Bhutan	2015	$3 million	Mountain Hazelnut Venture Private Limited (MHV) is a subsidiary of a holding company which is owned by a BVI-domiciled entity.	Active
12	IFC	Credence	Egypt	2015	$20.5 million	Credence Hospitality Limited (BVI).	Pending disbursement
13	IFC	Sphinx Glass SAE	Egypt	2015	$33.3 million	An equity investment of up to 20% in Sphinx Glass Ltd, a BVI entity.	Active
14	IFC	Labnet CIS	Central Asia	2014	$12.5 million	A project which is majority owned by a Labnet CIS Ltd (BVI).	Hold
15	IFC	CEI Water	China	2014	$70 million	CEI has a subsidiary, China Everbright Water Investments Limited which was incorporated in the BVI.	Active
16	IFC	ENN Energy	China	2013	$75 million	ENN co-founder owns it through ownership of ENN Group International Investment Limited, a BVI-domiciled company.	Completed
17	IFC	Zhaoheng Hydropower Holdings Ltd.	China	2013	$75 million	One of the company's shareholders is a Zhaoheng (BVI) Limited which is owned by another BVI business company, Zhaoheng Hydropower Ltd.	Completed
18	IFC	InterEnergy Holdings Inc.	Caribbean Region	2012	$50 million	IEH is owned by an investment vehicle managed by InterEnergy Partners Ltd who is a minority shareholder is InterBolsa Investments Ltd. (BVI). Also, IEH owns operating companies. One it owns via an indirect interest in Haina Investment Company Ltd. (BVI).	Active
19	IFC	ISC-Ibtikar Fund	West Bank and Gaza	2017	$1 million maximum	Ibtikar will be a limited partnership registered in BVI	Active
20	IFC	DCGCapitalMarket	Vietnam	2016	$50 million	DCGC is licensed in BVI	Active
21	IFC	Sonker Bunkering Company SAE	Egypt	2015	$97 million	The Sponsor of the project, who owns 63% of Sonker, was established in BVI.	Pending disbursement
22	IFC	Pan African	Tanzania	2015	$100 million	The sponsor of the project, a Canadian listed company, has a registered office in BVI.	Active
23	IFC	Muamalat SME	Indonesia	2014	$60 million maximum	Two of the shareholders of Bank Mumalat are investment companies domiciled in BVI.	Hold
24	IFC	Multibank Climate Smart and SME	Panama	2014	$40 million	Multibank Inc operates a subsidiary in BVI.	Active
25	IFC	Tobene	Senegal	2013	$46.22 million	The sponsor and co-developer is an international company incorporated in BVI.	Active

Sources: Capital Economics, European Bank for Reconstruction and Development and the International Finance Corporation

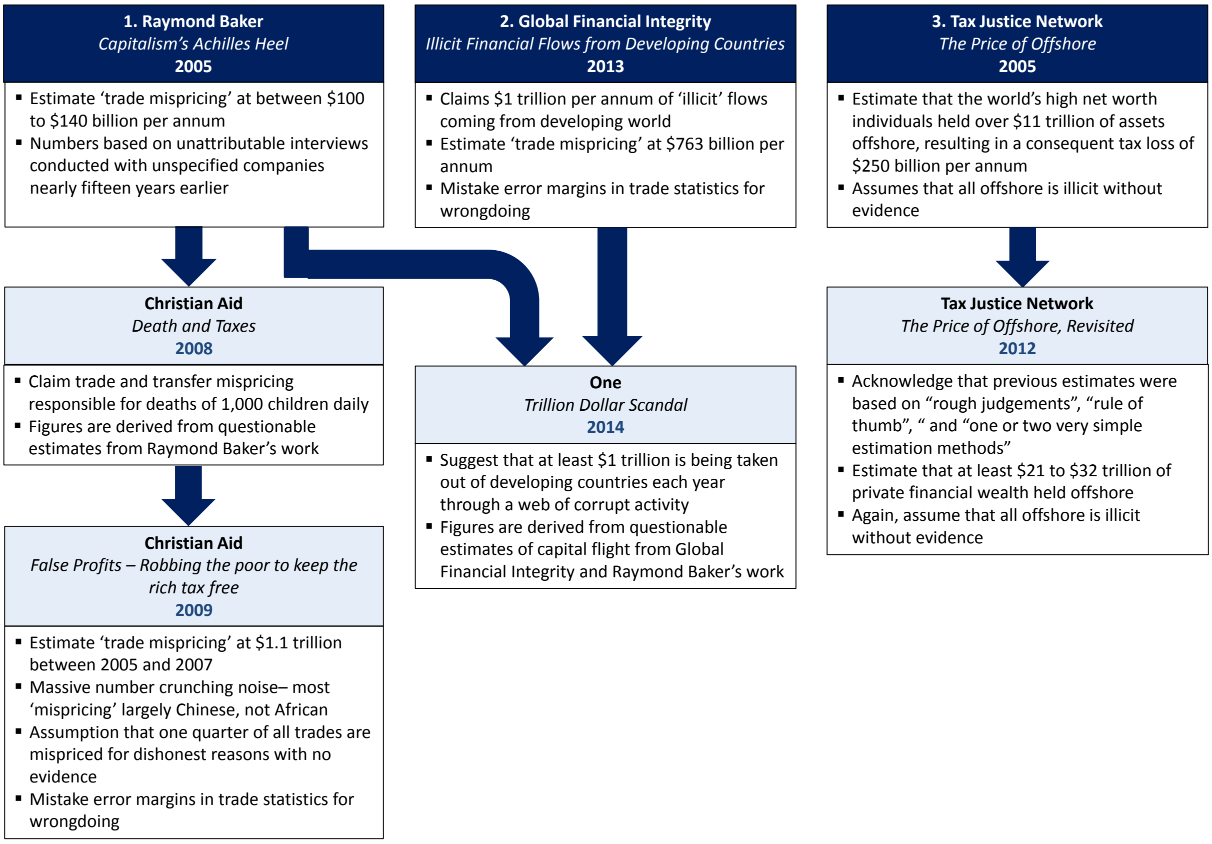
4. Headline grabbing numbers by campaigners that international financial centres hamper development in poor countries do not stand up to scrutiny

Some campaigners often claim that IFCs hamper development in poor countries. These often rely on inaccurate characterisations of them as secretive and poorly regulated, and allege their complicity in tax evasion and corruption – including asset-stripping of the world's already poorest nations. These headline-grabbing numbers do not stand up to scrutiny (see figure 2).

These analyses commonly fail to distinguish between legitimate trade between countries and illicit capital flows. They also assume that all money held offshore is illicit. Some rely on unattributed and unverifiable hearsay, including work done by Richard Baker, whose research is based on un-attributable interviews conducted with unspecified company executives in the 1990s.[2]

Others, including by Global Financial Integrity, assume that all errors within individual government's economic statistics and surveys, and the inconsistencies between different governments' statistics, can be attributed to illegal offshore activity.[3] Poor data are not evidence of wrongdoing.

Figure 2: Timeline and links between critiques of international financial centres



Sources: Capital Economics and various papers

[2] Raymond Baker, Capitalism's Achilles Heel – Dirty Money and How to Renew the Free-Market System (Wiley, Hoboken), 2005.
[3] Dev Kar and Brian LeBlanc, *Illicit Financial Flows from Developing Countries: 2002-2011* (Global Financial Integrity, Washington DC), December 2013.