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The transparency challenge facing private equity

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When hedge funds are set up in offshore centers, they benefit from favorable conditions when investing in Africa. Their investments may spur economies, but short-term profit targets, the lack of transparency and tax evasion do not contribute to the development of the continent. Enhanced tax controls, transparency and traceability of funds will help private equity investment become a full-fledged player in Africa's development.

Private investment (direct and portfolio) has been gaining impetus in Africa since the early 2000s, in line with the "Washington Consensus".1 In 2010, it had a stock of some USD 150 billion of assets and is gradually taking over from international finance institutions. The capital is mainly American, French and British, but Chinese and Indian investments, those from Gulf countries and inter-African investments (South Africa, Libya) are growing at a rapid rate.
Multinational investments in oil and mining countries continue to take the lion's share. However, there is a certain degree of diversification which does serve the interests of non-mining sub-Saharan African countries and benefit certain local small- and medium-sized enterprises (SMEs). The sectors include telecommunications, transport infrastructure, the textile industry, agriculture, tourism and the hotel industry and, last but not least, financial services.
Experts forecast that investment flows in Africa will be in the region of USD 150 billion by 2015. The bulk of these investments (80%) will continue to focus on the mining, metal, oil and gas industries, as well as natural resources exploration, driven by China's high level of demand for raw materials. The tourism and hotel industry are expected to receive 15%, while major sectors such as infrastructure and industry may each only obtain 4%.

Tax and legal arrangements adopted by private equity investors

Private equity investment features prominently in a new political-economic model that is coming into being in developing countries. What attracts it to Africa are both the positive prospects for economic growth and the high returns on investments, which are above those in other world regions, with the exception of Asia and emerging countries. The range of funds, investors and operators interested in the continent is expanding and diversifying and is helping certain countries such as Egypt, Kenya and Nigeria reach the "status" of "emerging countries", which is already the case for South Africa.

Investors exercise a high level of selectivity: political and government instability, the low level of security, wars in certain regions or the lack of transport infrastructure can be discriminating factors which penalize countries with rich mining potential. This is, for example, the case for the Democratic Republic of Congo and a handful of other countries. Other negative factors such as corruption are often deplored, but very rarely put off potential investors. The different private equity-friendly tax incentives and exemptions implemented by numerous African governments under the International Monetary Fund and World Bank Tax Consensus are viewed positively by operators. However, the lack of transparency in the terms under which they are generally granted is an obstacle to establishing a climate of confidence. They do, however, make it easier for fund managers to keep their promises of ambitious returns on investment – often over 25% – and to interest funds with alternative strategies, even hedge funds.

These funds very often operate via legal entities registered in Mauritius, the Caiman Islands, the British Virgin Islands and Bermuda, or from the offshore2 financial centers where they are established (Delaware in the United States, Luxembourg, Singapore, Switzerland and the United Kingdom). The different tax exemptions, particularly on capital gains and valuation gains, make this situation highly advantageous for them. In addition, these jurisdictions offer the possibility of maintaining funds' resources in convertible hard currencies. While most sub-Saharan African countries have non-convertible currencies and legislations that do not authorize offshore companies, they also make it possible to enhance risk coverage on currencies and deals and, in principle, to keep in check the real value of financial assets.

Short-term returns, lack of transparency and tax evasion

It may be a win-win situation for investors, but this is unlikely to be quite the case for countries. Admittedly, private equity investment does play a positive role by supporting job creation and the emergence of new projects; it provides existing businesses with capital for their development, helps stimulate emerging financial markets and create and modernize infrastructure. However, operating conditions in certain mines or agricultural sectors in which funds invest are also criticized for not complying with basic social imperatives and minimum environmental standards.

Although the increasingly active involvement of private equity funds generates a growth process which can create jobs and wealth in the African countries they target, it also raises three types of problem. First of all, their strategies are often based on extremely high profitability targets against a risk that is not always controlled; the consequences can prove disastrous for the host country: projects permanently halted, bankruptcy, disappearance of debtors, cost overruns, fraud, etc. The recent participation of hedge funds and speculative funds in pan-African investment vehicles (with capital raisings worth several hundred million dollars) shows that the target of high short-term returns has a strong influence on the tax and financial strategies of investors and fund managers. Private equity funds can consequently be tempted to take control of a local business merely to make a quick profit. This is made easier by a tax system which facilitates equity distributions and reductions during the first years. And yet local businesses generally require access to long-term equity and need to be able to rely on a stable shareholding structure. Africa has often attracted financial speculation, particularly in the mining industry; it is hoped that the arrival of private equity in other sectors does not lead to a similar result.

The lack of transparency in unregulated private equity investment poses another problem with its financial and tax arrangements in which funds are active players. It is based on the extensive use of offshore jurisdictions and financial centers where the funds, in addition to the tax facilities they benefit from or organize, are largely outside financial regulation and prudential standards. They are major players in shadow banking3 for which tax havens are most typically used. Funds registered in tax havens have practically no transparency and information obligations vis-à-vis the market or regulatory authority in terms of the identity of their owners or debtors, changes in their share capital distribution, their accounts or their level of debt, their strategies or their results. This lack of transparency also concerns the offshore debt of new entities, which are encouraged by the possibility of being able to deduct interest and are not submitted to any external control. It can be practical for investors and operators seeking discretion for political reasons to make use of the lack of legal and financial transparency of certain non-cooperative jurisdictions – whether they are from sovereign funds or the instruments used to take over raw materials reserves. But they can also be screens for the interests of Mafia figures or fraudsters seeking to geographically and sectorally diversify their investments and take advantage of host countries' needs for fresh capital in order to launder dirty money.

The third type of criticism concerns tax evasion, which is at the core of the system, with tax optimization arrangements that are often aggressive and combine exemptions in host countries with those offered by third-party non-cooperative jurisdictions. Transfer pricing manipulations on exports (particularly raw materials), which involve one or several tax havens between the exporting country and the actual importer, are one of the main reasons for local tax base erosion. This tax evasion is also fostered by loan interest deduction mechanisms, which have long benefited multinationals in the mining and trading sectors. They have even more strategic advantages for companies financed by private equity with strong leverage.4 All of this naturally undermines host countries' tax bases, weakens the local impacts of investments and encourages local authorities to "make up the difference" with parallel revenue systems. In the end, several tens of billions of dollars leave developing countries. This represents more than the amount of international aid.

Enhancing the impact of foreign investment flows

The crisis has revealed a pressing need for financial and prudential regulation from which financial "ecosystems" linked to Africa must not be exempt. By reducing the scope of unregulated areas and financial products and dependence on offshore banking,5 the virtual detour that investment funds make via tax havens would become less attractive. It would also limit the negative impacts of excessive leverage and investments in derivative products.
International finance institutions should also undertake not to provide their expertise or support to private equity fund projects that transit through non-cooperative jurisdictions.6 They may do so by referring to the criteria, recommendations or standards of the Organization for Economic Co-operation and Development (OECD), the Financial Action Task Force7 (FATF) and the Financial Stability Board8 (FSB).

It is a priority to fight against tax evasion, the main victims of which are the public finances of most developing countries in sub-Saharan Africa. This requires fighting against illicit capital outflows from host countries. They often stem from endemic corruption, circumvented exchange controls and fraudulent remittances of interest and dividends (linked in particular to private equity investments) towards tax havens.

The arrival of private equity investment must not mask the need for a more equal sharing of revenues between investors and States, within a balanced legislative and tax framework, that is investor-friendly and preserves the interests of local communities and States. The latter must, as certain emerging countries do, at the minimum provide for transactions concerning movable and immovable property in an investment operation (acquisitions, sales and capital gains) to be taxed where they are located and not where the platform company is domiciled. More generally, it involves fighting against aggressive optimization schemes aiming to artificially reduce local tax bases and reduce charges in order to locate the highest possible amount of profits in tax havens where they are tax exempt.

Tax transparency must also be made mandatory, notably to avoid abusive transfer pricing; sums paid by mining companies, revenues received by governments and expenditures made must all be disclosed. In addition, the fiscal relationship between the host country of the investment and the offshore center must be based on equitable rules and conventions on the exchange of tax-related information in compliance with the OECD standard. This must also be the case for the relationship established between the offshore center and the investor's country. It is advisable for the network of tax conventions, which has expanded significantly over the past two years with offshore centers, to be strengthened with new conventions. They must provide for the exchange of tax-related information to the OECD standard and must be signed between the offshore centers and the African countries receiving the foreign investments. Today, only five African States (Botswana, Ghana, Mauritius, Seychelles and South Africa) are members of the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes.9 Moreover, a number of offshore centers that serve as a hub for investments in Africa (British Virgin Islands or Hong Kong for example) do not always have relevant bilateral conventions which would allow an effective exchange of information with sub-Saharan African States.

Host countries of investments must build sound tax bases. This is essential for numerous African States. States must introduce tax base, collection and control systems for both corporate tax and capital gains tax on the businesses in which funds invest, and better regulate the different tax exemptions concluded between the authorities and operators. This also requires acquiring expertise in tax matters.

The need for transparency and traceability

Funds' use of investments based in offshore centers to invest in projects and businesses in Africa contributes to the lack of transparency which affects global financial circuits. Introducing greater transparency is essential in terms of ethics and good governance. But it is also the key condition for foreign capital flows towards Africa to truly support the development of countries targeted by investors, without, however, causing operators to lose interest.

This transparency requirement concerns all public stakeholders in investment: both the States that receive the investments and the offshore financial centers that often carry them. The international community expects them – particularly those affected by drug trafficking – to rapidly comply with FATF recommendations for the fight against money laundering in order to avoid any pollution of private equity investment. Transparency is also needed from operators, investors and direct beneficiaries – the identity of which must be known by tax authorities (under countries' adherence to the OECD standard) and by bodies dedicated to the fight against money laundering.

Initiatives for greater transparency are also expected in the mining and oil industry, with businesses undertaking to disclose their country-by-country results, the tax they pay locally (notably corporate income tax) and the dividends paid by a subsidiary. Increasing international involvement aims to foster good governance practices, such as the Extractive Industries Transparency Initiative (EITI),10 the main tool used in recent years to promote better governance of revenues from natural resource exploitation in producing countries. In order to promote the sustainable economic, social and environmental development of the sector, Africa must establish good governance practices at the national, regional and international levels.

Footnotes

1 The "Washington Consensus" presents a set of standard measures applied to economies facing difficulties as a result of their debt. It was designed by the World Bank and International Monetary Fund (both based in Washington) and is named after an article by the economist John Williamson, who in 1989 defined ten recommendations closely modeled on the ideology of the Chicago School. Its recommendations include financial liberalization, trade liberalization, market deregulation and the privatization of State-owned companies.
2 The term offshore is used to describe the creation of a legal entity in a country other than the one in which the activity is conducted in order to optimize taxation (tax haven) or financial capital management.
3 Shadow banking is a banking activity conducted by entities that do not receive deposits and, as such, are not regulated as banks.
4 Leveraging involves borrowing liquidities in order to increase the actual size
of the portfolio (initially only made up of funds provided by investors).
5 Offshore banking rapidly developed in the mid-1960s, thanks to the growth and liquidity of global financial markets. The range of services offered by offshore banks includes all deposits, transfers, credit facilities and investment management. They handle administrative procedures and provide all these services on a confidential basis.
6 Non-cooperative jurisdictions are areas which do not apply internationally adopted standards for transparency and the exchange of tax and financial information.
7 The Financial Action Task Force is an inter-governmental body with a mission to develop and promote national and international policies to fight against money laundering and the financing of terrorism.
8 The Financial Stability Board is an informal economic group set up during
the G20 meeting in London in April 2009. Its objectives relate to cooperation
in the field of supervising and monitoring financial institutions.
9 Since 2000, the Global Forum on Transparency and Exchange of Information for Tax Purposes has been the multilateral forum within which over 90 jurisdictions work. It is in charge of the in-depth monitoring and peer reviews of the implementation of standards for transparency and of the exchange of information for tax purposes.

10 The EITI is a coalition of States, businesses, civil society groups, investors and international organizations. It establishes an international transparency standard for the oil, gas and mining sectors. This standard is based on the publication of both amounts paid and collected by businesses and States.