THE FUTURE OF OFFSHORE FINANCIAL CENTRES

- Rereading the tealeaves from a Cayman perspective

by

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Introduction

The financial services industry is critical to the economic well-being of small international financial services centres (OFCs) such as the Bahamas, Bermuda, the British Virgin Islands (BVI), the Cayman Islands, the Channel Islands, Gibraltar and the Isle of Man. It is the major driver of the high per capita GDP figures. Some of these jurisdictions have thriving tourism industries also. But these, while welcome, tend for the most part to provide unskilled and low paying jobs.

Less well understood is the often beneficial role OFC's play in the allocation of global capital in legitimate ways. The picture often painted of OFC's by the 'noisy" media of shady places for shady people overlooks that the bulk of the flows through OFC's are legal and are a natural part of globalization.

After a volatile few years since early 2008, the financial services industry in OFC's is now slowly recovering from the global financial crisis. For the most part, OFC's have dodged the misdirected bullet that "offshore" was responsible for the meltdown. In Cayman, the hedge fund industry is renergised and is growing again, Asian IPO's are doing well, captive insurance is hanging in, but the debt side (securitization) is still quiet, albeit with some green shoots. Banking and fiduciary (trust) businesses are essentially flat. Overall, the recovery in OFC's is patchy as yet and they cannot afford to become complacent again on the basis it is soon to be "happy days are here again". They must continue to be vigilant to ensure their long term stability and success in the future.

Scenarios

First, some possible future scenarios for OFCs.

Scenario I – doomsday

- This outcome is the cataclysmic decline of these centres. One cause might be the major economic powers implementing domestic policies and programmes that eliminate the need to use OFCs. This would entail the introduction of well balanced regulatory and supervisory regimes and the reduction of tax rates and other costs to levels that made it impossible for OFCs to compete. If this were left to Ireland with its 12% tax rate, that might happen. But it seems remote in reality.

- An alternative and alarming cause might be the effective implementation of international agreements between the major economic powers not to compete on regulatory and tax matters, to establish common standards of (over)regulation and standardised (high) tax rates, to create a unified global tax and regulatory regime under the United Nations, OECD (Organisation for Economic Cooperation and Development) or other international organisation and to pass domestic legislation making it hard, if not impossible, for OFCs to be used legally. This outcome seems also rather unlikely, however much the EU (and some in the USA) in particular might like it.
- The final alternative would be the reintroduction of exchange/capital controls by all major economic powers, whereby regulatory approval is required to move funds cross border. This was the position in many countries post WWII until the late 1970's and early 80's, and many of us remember that well. The result might well be ghost communities relying on fishing and tourism reminiscent of the old gold and silver mining towns of the Western USA.

Scenario II – Nirvana

This outcome is the continued and unchecked growth of such centres driven by increased globalisation of financial markets, continued regulatory and tax arbitrage and competition between sovereign states and the welcoming of the useful role played by OFC's. And the pejorative distinction between "onshore" (good) and offshore (bad) disappears. The result will be thriving and much-loved OFC'S generating wealth for residents and non residents alike.

Scenario III – the curate's egg

This outcome is a mix of I and II, i.e. these centres will continue to exist, some will flourish and others die on the vine, but with continued attempts by major economic powers and blocks to reduce the advantages they can offer.

Scenario III is the most likely, and it will be interesting and challenging. I believe success will come to those jurisdictions that can genuinely add value to international transactions and are recognised as so doing. This in turn requires the right mix of a stable and transparent political, legal, judicial and economic environment, no or limited direct taxation or a good network of double tax treaties, a good risk based regulatory and supervisory approach, a flexible and adaptive approach to legislation and regulation to provide the structures, products and supervision expected by the market, a willingness to engage with international standard setters, foreign governments, regulators and law enforcement and tax agencies to agree mutually satisfactory standards of regulation and cross border assistance and law enforcement, modern infrastructure, a welcoming immigration policy to attract the expertise needed and an educated and motivated local work force,

Background

This paper does not give a detailed history of the development of the offshore financial industry. Nor is it productive to debate what an OFC is. Generally, if it looks like a duck, walks like a duck and quacks like a duck, then it is a duck and you know one when you see one. It is important to note that OFCs are typically places that facilitate international financial transactions rather than create them. To put this in perspective, London and New York are international financial centres and create the transactions; the Bahamas and the Cayman Islands are international financial services centres that play a role in their execution. It is a little like the difference between the place where Toyota designs its cars and the place where the transmissions are built. Of course, the goal of a financial services centre should be to develop into a true financial centre where products and structures are actually created as well as executed. To do that, it has to attract the necessary expertise. Examples of places that are well on the way are Hong Kong and Singapore. Dubai's early promise may have been set back for some years by its domestic real estate bubble and crash, but it is proving quite resilient.

The success of OFCs has depended on a variety of reasons. By and large, they all share a common platform of political stability, no or limited taxation, no or very flexible exchange control, sensible company, trust and regulatory and commercial laws, a commitment to confidentiality (subject to appropriate gateways for disclosure) and a welcome mat for legitimate international transactions, service providers and investors. Historically, many of the jurisdictions were or are in the UK fold as territories of one kind or another, e.g. Bermuda, the Bahamas (now independent), the BVI, the Cayman Islands, the Channel Islands, Gibraltar and the Isle of Man. Indeed, the UK encouraged these territories in the early days to develop as financial services centres to reduce the burden on the UK treasury. In similar vein, the Netherlands and the Netherlands Antilles. Others are independent nations such as Liechtenstein, Luxembourg, Panama and Liberia (the latter both noted particularly as ship registration centres).

But there is often a certain randomness as to why some centres developed particular areas of speciality. Often it was a mixture of timing, luck, spotting an opportunity, geographical convenience, personal connections or even a fortuitous double tax treaty (Barbados and the Netherland Antilles), rather than a logical analysis of the market and a targeted approach. For instance, Bermuda developed as the leading captive insurance domicile due to lack of capacity and high premiums in the US corporate market and its geographical convenience to the US Northeast and Midwest where many of these major corporations were based. It was also quite well placed for the London reinsurance market. Bermuda's expertise in this area provided the base for it to expand into the open market reinsurance business when the traditional US and European reinsurers were not meeting the needs of the market. The Channel Islands and the Isle of Man were well placed geographically, particularly for UK (and being within the Sterling area for exchange control purposes), European and, more recently, Middle East sourced business. The BVI became the offshore corporate Delaware in the late 1980's built on the instability of Panama during and immediately after the Noriega era. Many of the Panama service providers established operations in the BVI as a stable and low cost alternative to Panama and actively marketed it as such.

The Cayman Islands first developed as an offshore banking centre in the 1970's, following perceived political instability in the Bahamas during the lead up to and post independence. The principal reason originally for the development of the Eurodollar market (as it was called) was the introduction of US domestic regulations that made it far more cost effective for banks and corporations to borrow and lend US$ outside the US. That market continues today (but for very different reasons) and the total footings of Cayman licensed banks are now around US1.6 trillion. The Cayman Islands diversified from the banking base into general financial and capital markets, fiduciary (trust/private client), captive insurance (initially largely due to some missteps by Bermuda), mutual funds and general corporate business. Today, it is probably best known for being the major offshore banking and hedge fund domicile and one of the leading captive insurance domiciles.

To build an OFC takes time. And it can be threatened very easily as the business is of essence quite easy to move. It does not have bricks and mortar or much physical equipment. The Bahamas lost considerable business in the late 1970's and early 80's in the run up and post independence due to aggressive nationalism. Panama suffered greatly during and after the Noriega years. Interestingly, both the Bahamas and Panama defied predictions and are once again doing quite well. They would make two very interesting case studies. The Netherlands Antilles had an extremely helpful double tax treaty with the US that made it a major centre for US corporate borrowing in international markets. So successful indeed, that the US eliminated the benefits with the stroke of a pen (a fate that awaits any such treaty where one side benefits far more that the other). The Netherlands Antilles have struggled as a financial services centre ever since. Little remembered is that the BVI once had double tax treaty with the UK. That also received the UK pen treatment. But the BVI did recover and has become the leading offshore corporate domicile.

International Threats

OFC's have been wrestling with the alphabet soup of international initiatives for some time. Acronyms like BIS (Bank for International Settlements), EUSD (European Union Savings Directive), FATF (Financial Action Task Force), FSB (Financial Stability Board), IAIS (International Association of Insurance Supervisors), IMF (International Monetary Fund), IOSCO (International Organisation of Securities Commissions), OECD and UNODC (United Nations Office on Drugs and Crime) roll off the tongue. Despite these, or because of them as some would claim, many but not all, OFCs have thrived. The initiatives continue apace, particularly with respect to cross border assistance, principally exchange of information in an ever-broadening range of areas, including tax.

It is trite to say that responsible OFC's wish to deter abuse of their financial services, to punish those who do and to cooperate cross border with other jurisdictions with equivalent standards and legitimate interests. It is equally trite to say that such OFC's wish to implement and maintain sound and effective regulatory regimes that provide the right framework for financial transactions and balance the interests of suppliers and buyers of financial products and service providers. The stated goal of most major jurisdictions is to provide a global environment where legitimate capital can flow cross border into investments and financial products free from arbitrary barriers or controls. OFC's that implement the various international initiatives are lead to believe they will not be discriminated against, will be allowed to participate and thus will benefit economically. But the reality to-date is rather different.

A few years ago, a Commonwealth Secretariat paper concluded that three OFC's (Barbados, Mauritius and Vanuatu) could not show tangible benefits from implementing the recent international taxation and anti money laundering/countering the financing of terrorism initiatives. A similar review has not been carried out in Cayman. Anecdotal evidence is not so much that Cayman has suffered; rather it has not thrived as well as it could have absent the often burdensome and costly compliance requirements that have distracted Government and the industry from continuing the innovative developments for which Cayman has become known . The final communiqué from the Commonwealth Ministers meeting in 2007 specifically recognized the heavy compliance costs for OFCs and called for a more inclusive process in setting international standards. Some lip service has been paid to this suggestion and, for instance, OFC's are now having greater participation in the development of international standards and in the peer review of effective implementation. A good example is Cayman's (and other OFC) membership of the OECD Global Forum on Taxation that is working on increasing cross border transparency in tax matters. Another is the participation by Bermuda in the IAIS development of its Multilateral Memorandum of Understanding.

Reading the tea leaves reveals five particular points:

- First, there is still no meaningful level playing field. The reason is anti competitive behaviour. Many jurisdictions that pay lip service to free market economics only mean it when it applies to others, i.e. others should open their markets to their products, but not vice versa. And in financial products OFC's can pose a major competitive threat. So, for instance, the UK and the US are not keen to see OFC's thrive too much, but they recognize that, for their own financial service industries to be competitive and to secure inward foreign investment, they must allow their service providers to use OFC domiciled structures and permit investment from OFC's, otherwise they risk their service providers migrating to OFC's or losing inward foreign investment. Serious competition also exists between the UK (London) and the US (New York). The UK and the US are benign compared with others. Some major EU members maintain dirigiste economic models that are under serious financial pressure from the weight of an ageing entitlement society. Their fear of leakage of capital and revenues is such that their goal is to eliminate OFC's. So, while loudly trumpeting their support for globalization of financial services and the desirability of opening all markets to services and products, they continue to impose unequal, burdensome and anti competitive regulation on OFC's and continue to maintain barriers to their residents using OFC's and to OFC financial products being sold in their local markets. The EU is becoming increasingly aggressive post the financial crisis, and the recent Alternative Investment Fund Managers Directive bears all the marks of misguided protectionism (if the EU can get away with it). The BRIC countries have been less aggressive in the past, as they tended to benefit from large amounts of inward investment from OFC's. But recently some of these, particularly India and less so China, have become more questioning of the use of OFC's as they fear that they are losing tax revenues (and control of capital) through OFC structures for both inward and outward investment.
- Second, the acronym standard setters referred to above and driving the international initiatives are the creatures of and funded and staffed by the very same major countries that have no real interest in a level playing field open to OFC's.

- Third, there is the natural tendency of bureaucracies to be self-serving and self-justifying, particularly where they are unaccountable. The international standards setters (and the EU Commission) are just that. Their staff has little interest in finishing a project and, if it appears near to finishing, will develop a new or expanded programme. This is clearly evident in the international tax initiatives of the OECD and EU, and from the efforts of the FATF to avoid abolition. And they have every interest in preserving their tax free benefits packages. The most recent example is the manoeuvring of the OECD, through the Global Forum on Transparency and Exchange of Information for Tax Purposes, to become the judge, jury and executioner in tax information exchange compliance and to push the frontier beyond bilateral agreements to multilateral arrangements encompassing automatic/spontaneous supply of tax information.
- Fourth, there is widespread specific legislative and regulatory action to reduce or even eliminate the use of OFC's. The EU continues to push for an expansion of the Savings Directive (automatic reporting) to include broader types of income and "cut through' to the underlying beneficial owners of companies, trusts and partnerships. The Directive on Alternative Investments (even in its watered down form) presents and attempt to build "Fortress Europe" for the fund industry. The OECD and the FATF continue with their "name and shame" lists and effective implementation reviews of OFC's (while ducking attacking the deficiencies in major onshore jurisdictions). The UK Revenue has issued a "voluntary" code of conduct for UK banks under which they agree to abide by the spirit as well as the letter of the tax law. France has established the Evafisc to monitor offshore accounts. US has eliminated the benefit of offshore sweep accounts for corporate customers of US banks and the avoidance of dividend withholding tax through the use of synthetic instruments (derivatives). It has also enjoyed considerable success in its battle with Swiss banks that (may) have assisted US taxpayers to evade their US tax obligations by indicting certain of those banks and/or their officers. It is significantly expanding reporting obligations regarding foreign accounts and other offshore investments of US taxpayers (FATCA) and is considering expanding the automatic reporting of interest income earned by foreigners in US bank accounts and taxing reinsurance premiums paid to offshore affiliates. There is now heightened debate over corporations deferring tax by holding profits in OFC's, transfer pricing, carried interest and unrelated business income, all of which could have an adverse impact on OFC's.
- Last, and most importantly, reputational pressure is now getting real traction and is producing results in key areas. Continual political and special interest group pressure and media focus on finding scapegoats for the financial crisis, and disclosure of the use of OFC structures by major financial institutions and multinationals is having an adverse impact on OFC's. The goal is to make it unacceptable to engage even in lawful tax planning and avoidance. The UK media has given considerable critical attention to UK banks with offshore operations. France has pressured its major banks to close their operations in "paradis fiscaux". The EU Parliament adopted a resolution in 2011 demanding inter alia sanctions on financial institutions that "operate with tax havens". The European Investment Bank (EIB) has amended its lending policies so that loans will not be made to entities domiciled in jurisdictions that do not meet international tax information exchange standards. And the US President and

the Congress continue to proclaim loss of tax revenues to OFC's by both tax evasion and legal tax avoidance planning and the need 'to do something about it". The latest example of this is the President's Framework for Business Tax Reform is the latest salvo in this effort, ably supported by the Stop Tax Haven Abuse and similar moves lead by Senator Levin. In the meantime, a number of publicly listed holding companies domiciled in OFC's and with significant US connections have moved their domicile to jurisdictions that have full double tax treaties with the US. And finally, many US citizens living overseas are finding increasingly difficult to obtain normal banking services for their legitimate needs!

OFC Defences/Actions

There is a dangerous brew of self-interested behaviour by large countries and their client international standard setters. So what to do – certainly OFC's cannot safely ignore these developments and pressures?

- First, OFC's must ensure that their regimes meet currently accepted and applied international standards and are effectively implemented. In particular, OFC's must become more transparent and better at prompt and effective enforcement of their laws and regulations. Currently, they shoot themselves in the foot by defending outdated regimes and by encouraging Luddite attitudes in certain professional circles, make themselves an easy target for critics and lose high quality business for reputational reasons. Further, OFC's should learn which battles to fight. It may seem counterintuitive not to object to a financial transactions tax. But if everyone were to implement one, such a tax at a competitive rate would be a very useful additional source of revenue for OFC's.
- Second, OFC's must continually upgrade and improve their laws, regulations, infrastructure and Government and professional services to remain competitive in the financial services arena. For instance, OFC stock exchanges could start offering derivatives trading and settlement if the onshore rules become too burdensome.
- Third, OFC's must continue to engage with the key major jurisdictions and standard setters to shape and inform the development and implementation of fair international standards that create an inclusive and non-discriminatory playing field open to all legitimate OFCs and recognizes the equivalency of their regimes.
- Fourth, they must develop and implement networks of well crafted and mutually beneficial agreements with relevant jurisdictions for cross border assistance in terms of information exchange and law enforcement, subject to appropriate safeguards for legitimate confidentiality, due process and the rule of law.
- Fifth, they must remain vigilant and ensure their advance intelligence is as good as possible to ensure proactiveness rather than reactiveness.
- Sixth, better and more proactive political, media and educational campaigns are essential. There have been some successes as seen in academic papers and conferences showing the benefits provided by OFC's and commentary in the responsible media. However, these successes are still overwhelmed by extensive media coverage of strongly critical and inaccurate statements about

OFCs from foreign politicians, regulators, standard setters, adverse lobbying groups, charities and church groups (even the Vatican).

- Seventh, OFCs should join together (recognising they are also competitors) in building a cohesive group to conduct this engagement. Lonely tilting at windmills will not succeed. There has been remarkably little progress in this cooperation. Even the Channel Islands, Guernsey and Jersey, seem only sporadically to coordinate their efforts effectively.
- Eighth, OFC's need to seek out new sources of quality business in, for example, Asia, South America and the Middle East where the threats to their existence are considerably less. And where legitimate facilitators of global capital allocation are still welcome.
- Last, but perhaps most importantly, OFC's should strive to have real economic activity carried out and value added within their jurisdictions by the vehicles domiciled there…that means warm bodies in seats in physical offices in the OFC's making substantive decisions. And not simply delegating all those functions to third party service providers. This requires the appropriate local infrastructure and the right immigration policies and procedures to welcome the necessary expertise and to provide an educated and motivated local labour force. But this is probably the best defence against the "lack of economic substance" argument levied against OFC's.

This is a long term and many dimensional project and the challenges are formidable. To survive and thrive, Governments and the private sector in OFC's must devote the necessary resources and energy to the task. Those that can do what I am suggesting will be likely to succeed.

<u>Domestic Threats</u>

OFC's must also pay heed to domestic issues.

- OFC's must ensure that they continue to provide a stable and reliable political, legal, judicial, economic and social environment. International investors have little interest in locating their investment structures and transactions in jurisdictions where there are concerns about corruption, disregard for the rule of law and xenophobic hostility.
- It is imperative that the local community understands and supports its financial services industries and benefits from it. There is frequently insufficient effective engagement between the domestic stakeholders, who tend to take each other for granted. Unless the financial services industry is understood, trusted and supported by Government and the community, industry positions on issues such as a sensible application of the immigration regime, targeted legislation to enhance financial products and the regulatory regime, reasonable revenue raising measures and improved human and financial resources for relevant Government departments and agencies risk being seen as narrowly self interested and may fall on fallow ground.
- We see local expressions of dissatisfaction with the financial services industry (even in Switzerland) and questions raised about the industry's contribution to the broader community as a whole. These criticisms are broadly unjustified and unwise. OFC's typically do not simply "rent out" their legal and regulatory system and infrastructure to foreigners and without any benefit

resulting to the local community. One only has to look at other small islands in the Caribbean and elsewhere to see the value of the financial services industry. It is this industry, not tourism, that has given Bermuda, the BVI, Channel Islands and the Cayman Islands such high per capita GDP. After all, places such as the Dominican Republic and Jamaica dwarf Cayman in terms of its total tourism activity; not so in per capita GDP.

- It appears that Governments and the financial sector in some OFC's have become complacent; if so, they must both work harder to ensure that the broader community understands and remains convinced that the financial services industry is critical to the well-being of the Islands. Without strong and committed local support, the preservation and expansion of the industry in an increasingly challenging and competitive international environment becomes a daunting task.

Winners and Losers

So what might OFC's expect for the future?

- The pendulum is still swinging against OFC's for the moment. But unless the world goes back to the dark economic ages, the rhetoric (even from the French and Germans) should reduce and some semblance of balance will return.
- The world is full of global businesses and families. And their number and wealth (despite wealth destructors such as Bernie Madoff and Allen Stanford) should increase over time. The real growth will probably be in the new BRIC worlds and not so much the traditional (old) world of the G7/8.
- Expanding taxation and burdensome regulation will make proper planning for corporations and wealthy families even more important and also lead to greater demand for tax and regulatory advantaged and pleasant places to live and domicile, and where there is access to quality professional services and advice.
- Global economic competition inevitably means tax and regulatory competition. No-one has yet created the perfect tax or regulatory regime, so competing regimes (within broad agreed norms) are perfectly proper, just as there are many ways to make a safe automobile. Individuals and corporations are still entitled legally to maximise their wealth. Indeed, corporations have an obligation to their shareholders to do so. Saying loudly that "everyone should pay their fair share" (usually in fact meaning the other person should pay more) is rather meaningless. Ultimately, it is a question of what the law says and how the courts interpret and enforce it.
- Legitimate tax and regulatory planning will always have a place. OFC's with high standards of sensible regulation, appropriate transparency, cross border assistance arrangements and good infrastructure and providing quality value-added service have a valuable and vital role to play in this scenario.
- The barriers to entry as an OFC are ever increasing. The cost of developing the infrastructure and meeting international standards is significant and success cannot be achieved overnight or guaranteed. There are some who are trying it nevertheless, for example Dubai and more recently Ghana and Botswana. Whether they will succeed in the longer term is still an open question.

- There are probably now too many OFC's. Competition is increasingly fierce, and jurisdictions and structures are increasingly fungible.
- Darwin's theories argue for survival of the fittest. The OFC survivors will be those who are stable, transparent and soundly regulated, meet international standards, have an established infrastructure and track record (in all its aspects), tax/regulatory efficiency, professional expertise and support services, a solid and diverse base of business, and the ability quickly to adapt and innovate in the ever changing global environment and to add real value to legitimate international transactions and capital flows in an efficient and cost effective way.

Conclusion

So applying all this, what is the future for OFC's? Do they thrive as a financial services centre or go back to tourism, fishing and rope making (with meager handouts from aid agencies) until global climate change finally sinks them?

Many (but not all) OFC's meet the foregoing tests for being survivors and need not suffer death by a thousand cuts. But to really thrive as financial services centres, OFC's must learn better from history and from their and others' mistakes and work more effectively to be fully accepted as legitimate participants in the global financial world. These are challenges indeed.