OFFSHORE FINANCE

It is estimated that up to 60 per cent of the world's money may be located offshore, where half of all financial transactions are said to take place. Meanwhile, there is a perception that secrecy about offshore is encouraged to obfuscate tax evasion and money laundering. Depending upon the criteria used to identify them, there are between forty and eighty offshore finance centres spread around the world. The tax rules that apply in these jurisdictions are determined by the jurisdictions themselves and often are more benign than comparative rules that apply in the larger financial centres globally. This gives rise to potential for the development of tax mitigation strategies. McCann provides a detailed analysis of the global offshore environment, outlining the extent of the information available and how that information might be used in assessing the quality of individual jurisdictions, as well as examining whether some of the perceptions about 'Offshore' are valid. He analyses the ongoing work of what have become known as the 'standard setters' – including the Financial Stability Forum, the Financial Action Task Force, the International Monetary Fund, the World Bank and the Organization for Economic Co-operation and Development. The book also offers some suggestions as to what the future might hold for offshore finance.

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PREFACE

It has been estimated that up to 60 per cent of the world's money may be located 'Offshore' – which is the home of US$6.5 trillion of assets. Some 50 per cent of all financial transactions take place 'Offshore'. According to an IMF report dated March 2005, in respect of the Cayman Islands alone, 'the total international assets and liabilities held by Banks in the Cayman Islands were US$1.04 trillion'.[1] It has been suggested that 'the various offshore jurisdictions play a role in over US$1000 bn of business annually . . . [and that] . . . off balance sheet transactions now account for a growing portion of offshore business, so that the true scale of the uses to which sophisticated businesses make of the offshore centres is not apparent from their public documents'.[2]

Even allowing for a material margin of inaccuracy in the estimates, the figures quoted indicate that the global economic potency of the composite 'Offshore' environment is significant. The potential may be positive or negative; for example, 'Offshore' centres clearly perform a useful function which the volume of financial trade reflects. The quantum makes 'Offshore' a factor in, and therefore a potential opportunity in respect of, global financial stability. The text describes in detail why 'Offshore' centres add so much value. However, there is a potential threat also. It has been stated that '[t]he potential for financial system instability in an offshore country underscores the need to better understand the nature of OFC [offshore finance centre] activities and inter-linkages with the global financial system'.[3] This text attempts to contribute to that understanding.

[1] Cayman Islands: Assessment of the Supervision and Regulation of the Financial Sector, March 2005, Vol. II; *Detailed Assessment of Observance of Standards and Codes*, para. 7, p. 6.
[2] D. P. Kempe and G. Wood, *The Bermuda International Business Guide 2003*, ISI Publications Ltd, p. 5.
[3] *Offshore Financial Centres – The Role of the IMF*, 23 June 2000, p. 3.

The increasing competition for good quality business, mainland jurisdictions' concerns about how they will continue to finance budget deficits, the increasing frequency and extent of financial fraud and the overriding concerns about global money laundering and the financing of terrorism have all focused attention on financial environments and how they operate. The 'Offshore' financial environment is no exception. In the words of one commentator, '[i]t would be hard not to notice that something is going on offshore, even if the public do not know much about it, or whether it is a good thing or a bad thing'.[4]

Insofar as 'Offshore' is concerned, the focus culminated in three far-reaching and fundamentally significant reports by the Organization for Economic Cooperation and Development (OECD), the Financial Stability Forum (FSF) and the Financial Action Task Force (FATF) respectively. (Subsequently, the International Monetary Fund (IMF), the United Nations (UN) and the World Bank became involved also.) The reports underscored the quantum of business transacted 'Offshore' and prompted substantial further thought and action on the potential of the 'Offshore' environment. Without doubt, the 'Offshore Environment' has changed as a result of these reports and will change further as 'Offshore' attempts to optimise its potential in the global economic environment. The profile of 'Offshore' was raised significantly as a result of the amount of attention focused on it by the supranational bodies – but care should be taken to avoid any misunderstandings. Without a general awareness of the 'Offshore Environment', the rationale for such attention may be misinterpreted to mean something negative.

In fact, it is a positive development that currently more attention is being paid to 'Offshore' than ever before, and this book examines why that should be the case. The image and credibility of 'Offshore' is improving rapidly as jurisdictions understand their respective part in the global economy. The text attempts to place this increased interest into a meaningful perspective – but what is that perspective? Even those who are aware of 'Offshore' may not know a great deal about it – for example how might people in general – and financially oriented people in particular – define 'Offshore'?

While it would be convenient to begin with a definition of 'Offshore', it is not possible to do so – because there is some uncertainty about the meaning of 'Offshore'. According to some, this uncertainty is the direct

[4] Milton Grundy, Introduction, The OFC Report 2003, *Offshore Legislation 2003*.

result of the shroud of secrecy that envelops everything to do with 'Offshore'. However, the breadth and depth of information produced in this text suggests that the 'Offshore' environment is generally speaking not opaque. The absence of definitions need not thwart any attempt to find out what 'Offshore' means. In this respect, to enable some sort of framework to be established, some 'working definitions' are suggested in the chapters that follow. To underline the fact that the definitions suggested are merely means to an end (and not generally agreed), other than where it appears as part of a quotation, the word 'Offshore' will be shown within inverted commas in this text.

Despite the reasons, in the absence of factual information about 'Offshore', people are likely to default to anecdotal evidence, assumptions and estimates and will rely on 'secondary information' to form opinions, to make assessments and to draw conclusions. Such opinions and assessments are unreliable because they are based on perceptions that may or may not conform to reality. In fact, perceptions are an integral part of the 'Offshore' environment and sometimes they give rise to bizarre impressions – which in turn can lead to pejorative attitudes towards 'Offshore'. Frequently, perceptions combine fact and fiction and are often subjective – having been influenced disproportionately by extraneous factors that have little real bearing on the true scheme of things. The progression begins with a classification of a jurisdiction as an 'Offshore Centre'. Although it ought not, to some this infers some type of stigma – the reasons for which are explored in the text. Naturally, jurisdictions that might otherwise not object to being referred to as 'Offshore Finance Centres' (OFCs,) are not willing to be regarded or classified as such if that stigma attaches.

Perceptions can be insidious in many aspects of life, but, in respect of financial matters, they have a nasty habit of becoming reality. For example, if, in error, customers perceive their bank to be in financial difficulties, they might anticipate a run on the bank. As one nervous depositor reveals his anxiety to another, the probability of the actual collapse of the bank increases – to the extent that it might even become a reality. In short, wrong perceptions can potentially lead to disastrous consequences. In respect of 'Offshore', the perception is likely to gain momentum if there is no contrary action and message that are coherently presented to demonstrate otherwise. Those who are unwilling or unable to undertake appropriate research themselves or who – for whatever reason – do not know any different will assume that whatever they hear is true. The momentum gathers pace – and the negative stigma becomes a reality.

In the context of 'Offshore', there are ways in which facts are mixed with fiction. For example, it is generally true that many 'Offshore Finance Centres' are sparsely populated, tropical islands – where the main enterprises are finance and tourism. It is also frequently true that financial institutions in general and banks in particular which are located in such jurisdictions proliferate. There are likely to be many more banks than necessary for the business of the local community – which is almost certain to be small. Further, it is probable that the quantum of financial transactions processed through such centres will be extremely large both in value and in number. Probably, very large amounts of money will be held on deposit.

Having presented some of the facts, here is some of the fiction:

- 'Offshore' centres have more banks per head of population than other financial centres. Not true – for example, compare Lugano in Switzerland;
- there is no meaningful regulation 'Offshore', which means that virtually anything is possible there;
- the few rules that exist are benign, and even those are not really enforced;
- the unwritten rule is that few (if any) questions are asked;
- the only purpose that 'Offshore' serves is to help very wealthy people evade tax;
- the reason why everything to do with 'Offshore' is so secret is because all the business transacted has to do with tax evasion;
- 'Offshore' does not discourage money laundering; in fact, it is argued that the lack of rigour there encourages wrongdoing;
- money laundering is only possible because 'Offshore' jurisdictions will do anything to attract new business, so 'funny money' is acceptable 'Offshore';
- opening a bank account 'Offshore' is a mere formality;
- cash transactions are likely to be commonplace 'Offshore';
- 'brass plate operations' proliferate 'Offshore' (i.e. entities that are present only in legal form but without any physical presence or real substance);
- financial institutions operating 'Offshore' knowingly open accounts for money launderers and other criminals.

Here are some reasons why 'Offshore' is an enigma. First, it is axiomatic that 'Offshore Finance' is conducted in an island jurisdiction – referred to as an 'Offshore Finance Centre' – but even this is not always the case (e.g. the International Financial Services Centre in Dublin has been referred to as 'Offshore – Onshore'). It is irrelevant per se whether a person's bank is on the island of Manhattan or on the island of Mauritius. The quality and security of the financial environment is more important than whether the jurisdiction is an island or not.

Secondly, the 'quality' of the business that is conducted within the 'Offshore' environment is the key to its future. One commentator has said that '[i]n a world of 24 hour-a-day global markets and of integrated financial systems, having a mass of dirty money floating around the world threatens not just the markets but also western democracy'.[5] Subsequent chapters will examine this global phenomenon and indicate the extent to which financial institutions in both mainland and 'Offshore' jurisdictions have been used to warehouse 'dirty money' (the proceeds of crime – including tax evasion – or representing terrorist finance).

Tax evasion should be distinguished from tax avoidance. It is the legitimate right of every person to pay no more tax than is due. Fundamentally, 'Offshore Centres' provide efficient opportunities for taxpayers to arrange their affairs in such a way as to minimise their tax bills. Business 'Offshore' revolves around tax. 'Offshore Centres' have been successful but this has aroused strong suspicions in larger mainland jurisdictions that their success infers that it is not legitimately achieved. Other citizens – for whom the 'Offshore' route is not an option – have no sympathy because they are not prepared to condone someone else being able to enjoy an advantage which they cannot. 'Offshore' is a whipping boy – often disparaged and always mistrusted. The text tries to treat such suspicions objectively by enabling readers to compare like with like.

Thirdly, 'Offshore' is vulnerable – but perversely its vulnerabilities are exactly what make 'Offshore' attractive in the first place. They include: autonomy, confidentiality offered to investors, benign tax structures, and a tailored regulatory environment that is frequently less prescriptive than might be applied in mainland jurisdictions. These attributes are precisely what tax-sensitive corporations and individuals are looking for.

[5] J. Robinson, *The Laundrymen*, Simon & Schuster UK Ltd, 1998, p. 394.

Regrettably, fraudsters, crooks, money launderers, tax evaders and financers of terrorism are looking for exactly the same things – for other purposes. When something wrongful happens 'Offshore', it often attracts a great deal of attention but surprises no one because the general opinion is that 'Offshore' infers dubious business at best. When something wrongful happens in a mainland jurisdiction, it seems to receive less attention. Is this because it is regarded as commonplace and not newsworthy? No financial environment is safe from those who would exploit its advantages for wrongful purposes – so why should the same type of wrongdoing attract such diverse responses?

It is hardly surprising that, thus far, all attempts to define 'Offshore' or to suggest what it comprises, or which jurisdictions are 'Offshore' jurisdictions, and what particular traits or characteristics make them fall within the definition, have proved problematic. The reasons for all this uncertainty are explored in the text.

Meanwhile, in the words of Blaise Pascal, 'Let it not be said that I have said nothing new. The arrangement of the material is new.' In fact, much of the information presented is not new per se – but the construct in which it is presented is different to what has gone before – and it is hoped that a composite presentation of the information contained in the text may be of use in particular to those who work 'Offshore'. It is hoped also that, simultaneously, the construct adopted will not dissuade the casual reader while attempting to stimulate the interests of researchers to probe further. This might be achieved in a number of ways – but the optimum use to which this text might be directed is as a platform for subsequent study and research.

While there is a substantial amount of information available about 'Offshore', it is in myriad forms, and to a large extent it is unclassified and disjointed. The source of most information that is available is likely to be an article in a journal or in a newspaper. The footnotes aptly demonstrate this point.

At best, newspaper articles (and, to a lesser extent, articles in journals) about 'Offshore' are often helpful – but their publication is in response to a matter of current public interest. Matters arising are discussed in an uncoordinated fashion and, most often, the context is unclear. Books about 'Offshore' that combine related matters in a coherent and coordinated framework are not common. Often, the books that are available are promotional in nature – they combine advertising with information that is sometimes superficial. Many are written with a view to persuading readers to contact the author (or related persons) for advice on tax planning or fiduciary services. This text attempts to collate some of that information and to show some of the synergies arising from having done so.

The difficulties in researching 'Offshore' arise not only because existing information is not collated in any cohesive or coordinated or easily managed form, but also because there is a dearth of statistical information in particular. In this respect, the IMF has said that '[a]ll examinations of the role of OFCs in the international financial system have been hampered by a lack of adequate data'.[6] This means that we are less than totally aware than we should be of the potential benefits (and dangers) that characterise this part of the global economy. By extension, sub-optimisation of the environment's positive potential is likely, and, at worst, the extent to which 'Offshore' is or might be used for wrongful purposes will not be understood properly. For example, it is only with the publication of a paper on Best Practice for Corporate Services Providers (CSPs) in 2002 that there has been any real emphasis on setting standards in what is an increasingly significant area of 'Offshore' activity. Even though the services provided by CSPs have been a staple part of the 'Offshore' menu for many years (some jurisdictions have hundreds of thousands of entities incorporated therein), they have received scant attention until recently. However, the advances made have allowed some of the more progressive jurisdictions to adopt a regulatory response that leaves much bigger mainland centres (such as the UK) far behind.

A clearer perspective of 'Offshore' may contribute to the general store of knowledge and to our understanding of this integral part of the global economy. Ultimately, this enhanced level of understanding may lend something positive to the possible future uses to which the 'Offshore Environment' might be put. 'There is a need for a better understanding of the operations of OFCs and surrounding risks.'[7] Contrarily, unless the problems that exist are analysed correctly, the remedies suggested may not be appropriate. In short, it is suggested that any attempt to understand 'Offshore' is a valuable endeavour.

In respect of structure, the book is divided into three parts. The first third of the book (Chapters 1 to 9) sets the scene. It describes the context of 'Offshore' and identifies some of the problems that arise because of the lack of satisfactory definitions. Three different interest groups are

[6] *Offshore Financial Centres – The Role of the IMF*, 23 June 2000, p. 20.
[7] *Offshore Financial Centres – The Role of the IMF*, 23 June 2000, p. 7.

identified – the marketplace, service providers and consumers. Tax and regulation – the two factors that are at the very core of 'Offshore' – are examined in detail.

The middle third of the book (Chapters 10 to 12) focuses on the extent to which 'Offshore' has been criticised, and explores whether it is fair to blame 'Offshore Centres' for not doing more to disenable criminals from exploiting their jurisdictions by laundering the proceeds of crime 'Offshore'. Some of the problems that affect the global financial services network are considered. The extent to which the 'Offshore' environment has become the focus of global attention is perhaps best understood by reference to work undertaken at the end of the 1990s by the FSF, the FATF and the OECD. An analysis of the work of these three organisations is spread over three chapters. Whether there is any correlation between 'Offshore' and small island jurisdictions is considered briefly.

The last third of the book (Chapters 13 to 22) begins with a synopsis of how things stand currently. There is a comparison of two of the world's largest – and most respected – financial services centres – the USA and the UK. This leads to consideration as to whether 'Offshore' is really the cause of so many global woes or whether it is somewhat a scapegoat. This section attempts to summarise the problems and to identify some options for the future – after the FSF, FATF, OECD and the catastrophic events of 11 September 2001 in the USA. Finally, the book provides a checklist that consumers might use in deciding where to transact 'Offshore', and ends with some recommendations for the future.

ABBREVIATIONS

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
APG	Asia/Pacific Group on Money Laundering
ATS	Alternative Trading Systems
BCP	Basel Core Principles
BIS	Bank for International Settlements
CAD	Capital Adequacy Directive
CARICOM	Caribbean Community and Common Market
CCJ	Caribbean Court of Justice
CDD	Customer Due Diligence
CFATF	Caribbean Financial Action Task Force
COSE	Committee of South African Stock Exchanges
CPIS	Coordinated Portfolio Investment Survey
CSME	Caribbean Single Market and Economy
CSP	Corporate Service Provider
CTAG	Counter Terrorism Action Group
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ECOFIN	Council for Economic and Financial Affairs (of the EU)
EEA	European Economic Area (EU countries plus Norway, Iceland and Liechtenstein)
EIB	European Investment Bank
ESAAMLG	Eastern and Southern Africa Anti-Money Laundering Group
FATF	Financial Action Task Force
FINTRAC	Financial Transactions and Reports Analysis Centre (of Canada)
FIU	Financial Intelligence Unit
FSA	Financial Services Authority (of the UK)
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum

FSR	Financial Strength Rating
FSRB	FATF Style Regional Body
FSSA	Financial System Stability Assessment
G7	Canada, France, Germany, Italy, Japan, the United Kingdom and the United States
G8	Canada, France, Germany, Italy, Japan, Russia, the United Kingdom and the United States
GAFISUD	Financial Action Task Force on Money Laundering in South America
GCC	Gulf Cooperation Council
GIABA	Intergovernmental Group of Action Against Money Laundering in West Africa
GPML	Global Programme against Money Laundering (UN)
IAIS	International Association of Insurance Supervisors
IDB	Inter-American Development Bank
IFI	International Financial Institution
IMF	International Monetary Fund
IMoLIN	International Money Laundering Information Network
IMVT	Informal Money or Value Transfer System
IOSCO	International Organization of Securities Commissions
IRB	Internal Ratings Based
ISD	Investment Services Directive
ISMA	International Securities Market Association
ITIO	International Trade and Investment Organization
JMLSG	Joint Money Laundering Steering Group
KYC	Know Your Customer
MLAT	Money Laundering Assistance Treaties
MONEYVAL	Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures
MOU	Memorandum of Understanding
NCCT	Non-Cooperative Countries and Territories
NCIS	National Criminal Intelligence Service (of the UK)
NPO	non-profit organisation
ODCCP	Office for Drug Control and Crime Prevention
OECD	Organization for Economic Cooperation and Development
OECS	Organization of Eastern Caribbean States
OFC	Offshore Financial Centre
OFSI	Office of the Superintendent of Financial Institutions
OGBS	Offshore Group of Banking Supervisors

OGIS	Offshore Group of Insurance Supervisors
PC-R-EV	See MONEYVAL
PEP	politically exposed person
ROSC	Report on Observance of Standards and Codes
SADC	South African Development Community
SAR	Suspicious Activity Report
SDE	Small and Developing Economies
SIB	Securities and Investment Board (of the UK)
SIE	Small Island Economies
SRO	self-regulatory organisation
STR	Suspicious Transaction Report
SWIFT	Society for Worldwide Inter-bank Financial Telecommunication
TA	Technical Assistance
TIEA	Tax Information Exchange Agreement
UCITS	Undertakings for Collective Investment in Transferable Securities
UNODCCP	United Nations Office for Drug Control and Crime Prevention
VAR	value at risk
VOI	verification of identity
WCO	World Customs Organization
WTO	World Trade Organization