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Offshore financial centers

Rogue players or useful refuges?

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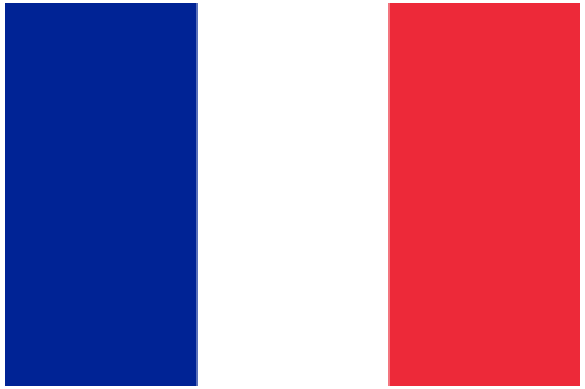
Outline

– Motivation
– What is an offshore financial center?
– Offshore vs. onshore finance
– Arguments pro and against OFC
– Policy measures with respect to OFC
– Conclusion

Motivation (1)

Motivation (2)



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Definition of offshore financial centers (OFC):

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OFC – center, where	The bulk of financial sector activity is offshore on both sides of the balance sheet;
	The transactions are initiated elsewhere;
	The majority of the institutions involved are controlled by non-residents.

Examples for use of OFC:

- **Offshore banking licenses**;
- **Offshore corporations or international business corporations (IBCs)**;
- **Insurance companies**;
- **Special purpose vehicles**;
- **Tax planning**;
- **Tax evasion and money laundering**;
- **Asset management and protection**.

Countries, territories, and jurisdictions considered to be an OFC

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Africa	Asia and Pacific	Europe	Middle East	Western Hemisphere
1. Djibouti 2. Liberia (J) 3. Mauritius (OG) (FSF) 4. Seychelles (FSF) 5. Tangier	1. Cook Islands (FSF) 2. Guam 3. Hong Kong, SAR (J) (OG) (FSF) 4. Japan 5. Labuan, Malaysia (FSF) 6. Macao, SAR (FSF) 7. Marianas 8. Marshall Islands (FSE) 9. Micronesia 10. Nauru (FSF) 11. Niue (FSF) 12. Philippines 13. Singapore (J) (OG) (FSF) 14. Tahiti 15. Thailand 16. Vanuatu (J) (OG) FSF) 17. Western Samoa (FSF)	1. Andorra (FSF) 2. Campione 3. Cyprus (OG) (FSF) 4. Dublin, Ireland (FSF) 5. Gibraltar(OG) (FSF) 6. Guernsey (OG)(FSF) 7. Isle of Man (OG) (FSF) 8. Jersey (OG) (FSF) 9. Liechtenstein (FSF) 10. London, U.K. 11. Luxembourg (FSF) 12. Madeira 13. Malta (OG) (FSF) 14. Monaco (FSF) 15. Netherlands 16. Switzerland (FSF)	1. Bahrain (J) (OG) (FSF) 2. Israel 3. Lebanon (J) (OG) (FSF)	1. Anguilla (FSF) 2. Antigua (FSF) 3. Aruba (J) (OG) (FSF) 4. Bahamas (J) (OG) (FSF) 5. Barbados (J) (OG) (FSF) 6. Belize (FSF) 7. Bermuda (J) (OG) (FSF) 8. British Virgin Islands (FSF) 9. Cayman Islands (J) (OG) (FSF) 10. Costa Rica (FSF) 11. Dominica 12. Grenada 13. Montserrat 14. Netherlands Antilles (J) (OG) (FSF) 15. Panama (J) (OG) (FSF) 16. Puerto Rico 17. St. Kitts and Nevis (FSF) 18. St. Lucia (FSF) 19. St. Vincent and Grenadines (FSF) 20. Turks and Caicos Islands (FSF) 21. United States 22. Uruguay 23. West Indies (UK) (J)

Source: based on Errico and Musalem (1999), IMF Working Paper WP/99/5

Legend:

(J) = Joint BIS-IMF-OECD-World Bank Statistics on External Debt; (OG) = Offshore Group of Banking Supervisors.

(FSF) = Financial Stability Forum's Working Group on Offshore Financial Centers.

Scale of international banking activities in major offshore financial centers

	GDP (latest available)	BIS banks' locational claims (end-2000)	
	US$ billions	US$ billions	*Multiple of GDP*
Bahamas	5.6	172	31
Bermuda	2.4	32	13
British Virgin Islands	0.3	25 [a]	86
Cayman Islands	0.9	482	518
Crown Dependencies	4.6	234 [b]	51
Luxembourg	19.3	245	13
Hong Kong	159	193	1.2
Singapore	85	221	2.6
United Kingdom	1,442	1,508	1.0
United States	9,152	2,096	0.2

Sources: BIS, World Bank, CIA and Bank of England.

(a) Banking data include claims on other jurisdictions in the British West Indies.

(b) Jersey, Guernsey and the Isle of Man. Banking data are total liabilities of banks and building societies to non-residents converted from sterling at the end-2000 rate of US$ 1.4950/f.

What are some common reasons why countries seek to develop themselves as offshore financial centers?

The country may have little land base and few opportunities to develop other types of economic activity because of:

- Limited energy supplies at high cost
- Limited raw materials and other natural resources
- Long distance from raw material and energy sources so secondary manufacturing options are few

The country may possess natural characteristics that make it an ideal offshore financial center:

- Political stability
- Close geographical proximity to wealthy countries
- Well educated workforce
- Some natural amenities that make it possible to develop its potential as a tourist attraction
- A political willingness to pass bank secrecy laws and at the same time be prepared to invest in security infrastructure to assure personal safety and to address the potential to attract unsavory elements.

What reasons do clients have to become associated with an offshore financial center?

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Legitimate reasons:

- Privacy for personal, family, business or political reasons (purposes)
- Try to keep funds separate in case of inheritance battles, divorce or personal bankruptcy
- Keep funds in a secure bank in a secure country

Illegitimate/Illegal reasons:

- Launder money from criminal activities
- Evade taxes

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Financial services offered by OFCs

- International banking;
- Headquarter services;
- Foreign direct investment;
- Structured finance;
- Insurance;
- Collective investment schemes;
- Other services.

Can offshore and onshore markets coexist?

	Offshore financial centers	Onshore financial centers
1. Definition	Based outside a specific country, especially in a place where taxes are low;	Based in the home country;
2. Currency market (Ericco and Musalem, 1999)	Offshore market separates the currency of denomination from the country of jurisdiction	Onshore market uses the home currency
3. Difference in tax system	Offshore financial centers have low taxes or no taxes.	Onshore financial centers have different tax system with high or medium taxes.

If the offshore market provides a similar service at a lower cost, what prevents all onshore transactions from migrating there?

- Offshore depositors bear the additional risk of exchange controls or taxes, plus the inconvenience of having deposits outside the home country.
- For borrowers, size and credit quality may act as barriers that restrict some firms from access to the offshore market.

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Benefits of Offshore Financial Centers:

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- Contribution to economic growth (Hong Kong, Singapore);
- Reduction of transaction costs;
- Low or no taxes;
- Services are provided mainly, but not exclusively, for nonresident clients;
- There are no or few foreign exchange controls;
- Geographical proximity to a major economy and good communications infrastructure;
- A legal regime that upholds bank secrecy;
- A high degree of political stability is also important – no one wants to put their money into a country that cannot guarantee personal safety or the ability to extract one’s funds.

Economic efficiencies of offshore financial centers

1. Lower transaction and liquidity costs;
2. Lower cost of insurance, hedging, and derivatives;
3. Increased market depth & promptness of executions;
4. Less volatility and fewer pricing anomalies;
5. International unification of trading rules and requirements.

What are the benefits of OFCs on the example of Caribbean countries?

- Income from direct employment
- Benefits via spillovers to other sectors in the economy including other services (such as tourism) and infrastructure (e.g. telecommunication and transportation)
- Government revenue from taxes and fees

Caribbean Countries: Selected Indicators of Economic Contribution of OFCs, 2008

	Antigua and Barbuda	Bahamas	Barbados	St Kitts and Nevis
Total Assets (US$ billions)	2	800	50	…
in percent of GDP	64	105	1,300	…
Government revenue from sector				
in percent of total revenue	0.2	0.05	11	2.1
in percent of GDP	0.05	0.01	4	0.8
Employment in the sector	271	1,163	3,500	…
in percent of banking sector employment	…	23	…	…
in percent of total labor force	…	…	2.5	…
Average salary in sector (US$)	9,630	74,200	…	…
ratio with domestic sector	…	1.7	…	…
Contribution of sector to GDP (in percent) 1/	1	7.4-9.2	7.8	…

1/ Staff estimates based on contribution of this sector to revenue flows, employment and services.

Arguments against OFC (1): Tax evasion

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- Concerns by higher-tax countries
  - Erosion of domestic tax collection
  - Contribution to excessive tax competition

- OFCs ≠ tax havens

- Tax haven status without significant role in attracting capital flows

- Tax havens imply benefits for high tax countries
  - Facilitate effective operation of tax systems
  - Encourage investment in high-tax countries

Arguments against OFC (2): Risk for financial stability

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- Claim: OFC increase risks for financial stability

- Major criticism:
  - Weak (or lack of) regulatory frameworks
  - Existence of tax avoidance schemes
  - Lack of transparency due to secrecy rules

- OFC provide favourable environment for:
  - Hedge funds
  - Shell companies
  - Special purpose entities
  - Money laundering

Arguments against OFC (3): Risk for financial stability

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- Concerns regarding hedge funds based in OFC:
  - Encouragement of regulatory arbitrage
  - Supervisory gaps
  - Lack of information

- Policy measures to reduce risks

- Is there more than meets the eye?
  - Self-interest of OFC
  - Behavior of developed countries, esp. US & UK

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Policy measures with respect to OFC:

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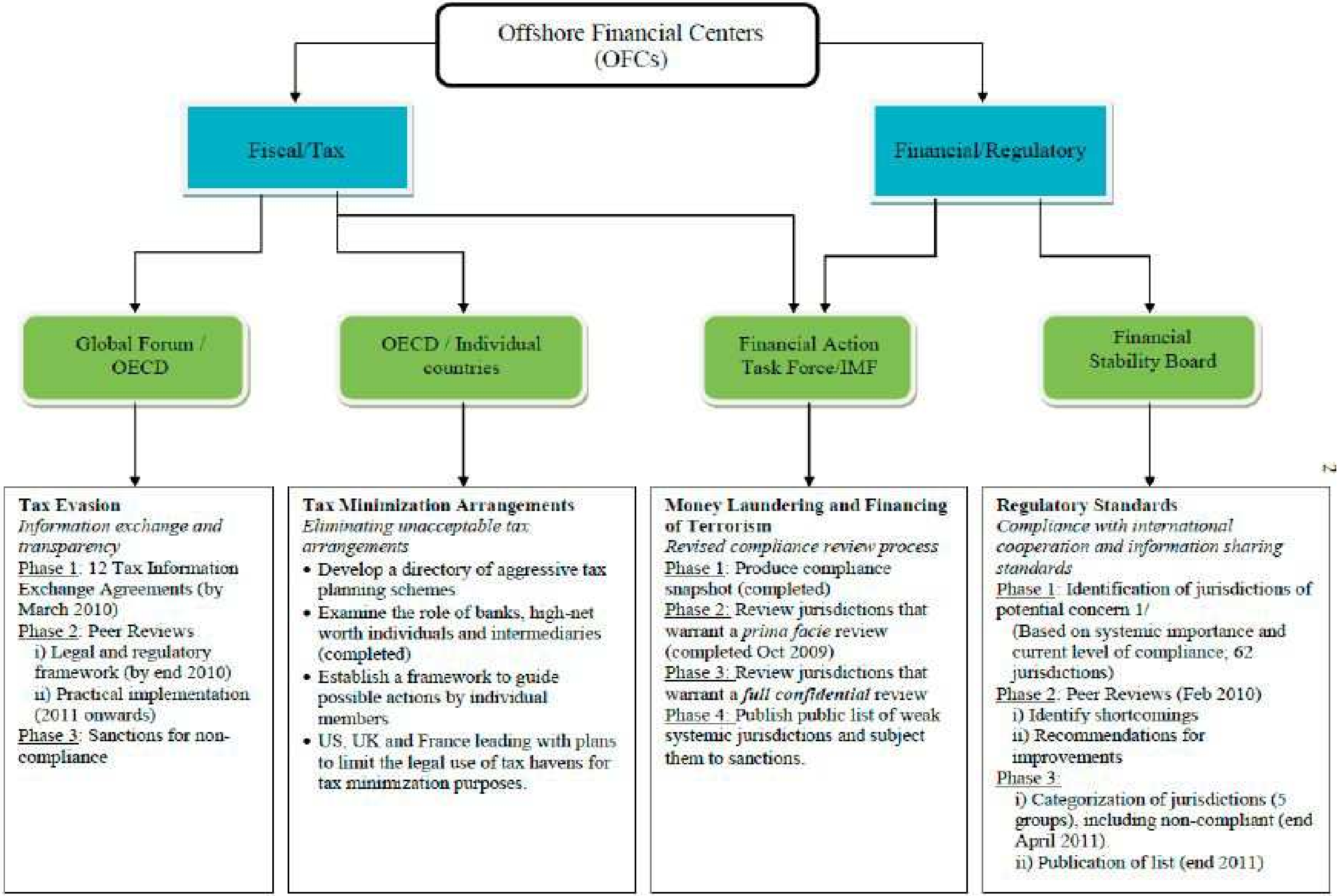

Source: IMF (2011), p. 10

Next steps in developing OFC

- Move towards multilateral agreements
- Improve the effectiveness of automatic exchange of information
- Create an offshore compliance network
- Put tax compliance in the broader context of countering illicit activities

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Conclusion

- Offshore financial services seen as important and vital part;
- Implications of global economic and financial crisis have accelerated efforts by advanced economies to increase revenue and strengthen global financial systems;
- Global initiative are targeting OFCs and the tax and regulatory environments in which they operate;
- Faced with a more challenging global environment, including more subdued tourism related growth prospects, search for areas to diversify economies.

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