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International Financial Centres

Economic development and the financial sector

Introduction

Many developing countries are looking to the development of a significant financial sector as a key to economic development. This approach has been stimulated by the increasing globalisation of financial and capital markets resulting from financial and economic liberalisation.

Threats to development

The expansion of global financial markets has not been without its problems. There has been increased volatility of capital flows as money has moved from market to market in search of short term returns. This is an issue that is already concerning Commonwealth governments.

A comparable threat comes from the increasing quantities of criminally derived and criminally controlled money flowing through the international system. These flows do not necessarily respond to normal economic stimuli, moving instead in response to changes in banking secrecy, or financial regulation. Such movements result in unpredictability and hence the instability of financial institutions through which they occur.

This instability should be of particular concern to those governments seeking to establish or develop their financial sectors. Criminal money may flow rapidly into new centres, providing an illusion of success and a short term boost to national savings. They may equally flow away rapidly as conditions change, attracted by another centre, or merely moving to complicate detection.

Combating instability

Those governments that resist the temptation to soak up short term flows from money laundering are likely to find themselves laying the foundations of a financial sector that can make a contribution to the economy over the longer term. By setting high standards of financial regulation, and by introducing effective money laundering countermeasures, they are likely to attract high quality financial institutions, which will not only provide a source of revenue directly, but which will contribute to wider economic development within the country.

While this point is relevant to all countries, it is particularly crucial to those seeking to develop as international financial centres.

The key feature of an international financial centre

Introduction

For the purposes of this paper, International Financial Centres (IFCs) may be defined as jurisdictions which are seeking to achieve a significant proportion of their economic development through attracting financial services activity. This activity is primarily conducted on behalf of non-residents, and may involve special tax concessions or bank licensing arrangements to cater for this "offshore" business. IFCs are often referred to as "Offshore Centres", or as "Tax Havens".

The attractions of IFCs

IFCs tend to attract business through offering a range of financial and professional services, combined with an attractive tax regime. Not all centres offer all services: some seek to specialise in particular niches. Key elements in IFCs include:

- **favourable taxation.** This may involve: very low (even zero) rates of corporate and

personal income tax for all or selected classes of companies and individuals; no withholding tax on bank interest or corporate dividends; and special arrangements with selected countries under dual-taxation treaties;

- **banking services.** Banking operations may be established on a "managed basis" where a bank with a physical presence in the jurisdiction manages a "booking operation", accepting deposits on behalf of a branch or subsidiary of another bank which has no physical presence. Deposits booked within the jurisdiction would be subject to local tax and legal requirements;
- **company formation and management.** Special classes of corporate entities (often known as "International Business Companies" (IBCs) or "exempt companies") may be created, often at very short notice, within the jurisdiction. Such companies would be able to hold assets and conduct financial transactions. Disclosure requirements are usually minimal for these companies, and they are often exempt from tax on any of their activities;
- **insurance.** The tax and regulatory structure may be attractive to insurance companies, particularly "captive insurers" – effectively separately incorporated self- insurance schemes;
- **trust business.** Asset protection trusts and other similar arrangements can be established to place assets out of the reach of lawsuits or similar demands. These may involve the use of IBCs as well as trusts;
- **confidentiality.** Commercial and financial confidentiality may be enshrined in statute, and subject to criminal penalties, rather than remaining a matter of Common Law.

While all these factors are designed to assist legitimate business activities, particularly when those activities are commercially or politically sensitive, they may also prove to be attractive to money launderers seeking to hide their illicitly gained assets. Those countries seeking to develop as IFCs must therefore be careful to deter criminal money, while still attracting legitimate international business.

The competitiveness of ifcs

Introduction

Because they look for business outside their own jurisdictions, IFCs are, to a greater or lesser degree, in competition with each other. This is particularly true of centres within the same time zone: all Caribbean and Caribbean Rim IFCs are effectively competing for business from the United States, Canada and Latin America. Pacific IFCs are competing for business from East Asia and Australasia. Some areas of IFC activity are not so dependent on time zones, and IBCs in particular may be used by customers worldwide.

This high level of competition tends to make individual IFCs reluctant to take any step that might cause them to lose business to a rival centre. Past experience has demonstrated that changes in tax regimes, or political instability can cause very rapid outflows of business. Indeed many offshore trusts are established in such a way that they can move to a new jurisdiction overnight, in the face of any threat to their situation.

Reputation

Because of the sensitivity of much IFC business to any threat, real or imagined, to their situation, IFCs must move carefully in introducing new legislative or regulatory positions. However the business is also likely to be sensitive to any scandal occurring within the jurisdiction, especially if it is related to the financial sector.

Several international financial centres that have attracted business through low regulatory standards and minimal vetting of bank licence applicants have subsequently suffered badly from the collapse of financial institutions, and the uncovering of fraud and money laundering within their jurisdiction. Such centres have sub-

sequently found it very difficult to re-establish themselves as viable financial centres.

However, where reasonable standards have been maintained, it has been possible for some IFCs to introduce progressively tighter regulatory requirements and money laundering legislation without losing much business. What little that has been lost has soon been replaced by new, higher quality business, attracted by the higher standards that have been introduced.

Collective action

The key to this success has often been a collective recognition by IFCs that higher regulatory and legislative standards are likely to have net overall benefits. This has led to collective action. The Caribbean Financial Action Task Force (CFATF) – to which 12 Commonwealth countries and 6 British Dependencies belong – is a good example of this. The CFATF was established at a Caribbean Drug Money Laundering Conference in Aruba in 1990, and has gradually developed as a regional initiative, with over two dozen members and a small secretariat. Members of CFATF have been prepared to move faster together than any individual members would probably have done separately.

Another example of collective action has been the work of the Offshore Group of Banking Supervisors, which was originally established to act as a central point of contact between a number of IFCs and the Basle Committee. This grouping has established a set of minimum standards for all its members (including implementation of the FATF Recommendations), and has recently evaluated its membership against those standards.

As an organisation containing most of the established IFCs, the Commonwealth is particularly well placed to take this exercise further. The commendation by Heads of Government of the FATF Recommendations, and the agreement by both Law and Finance Ministers to work collectively to combat the laundering of the proceeds of all types of serious crime provides a basis for co-ordinated progress among all Commonwealth countries.

Issues for discussion

What obstacles exist to collective action to introduce money laundering legislation? What role can Commonwealth Finance Ministers play in encouraging Commonwealth and non- Commonwealth IFCs to introduce effective regimes?

Regulatory standards

Introduction

The role of the regulatory authority is critical to the success of an IFC. The regulatory authority, in conjunction with the government, must maintain sufficiently strict authorisation criteria to keep away unsound financial institutions, while attracting a sufficient number of high-quality applications to maintain a viable sector. While the individual reputation of each IFC plays a major part in the second criterion, it is the determination and skill of the regulatory authority that ensures success with the first criterion.

Conflicts of interest

The biggest problem for regulatory authorities is the possibility of conflicts of interest arising between the promotion of the financial sector and its regulation. This can be exacerbated by political involvement in financial institutions or overambitious targets for growth of the sector.

Such conflicts of interest cannot always be avoided, but they can be addressed in a number of ways. These include:

- the separation of responsibility for regulation and promotion as far as this is possible;
- prohibition of any active involvement by serving members of the government in the running of financial institutions; and
- the full declaration of any interests in a decision by all those with any responsibility for it.

Relationships with overseas authorities

By their nature, regulators in IFCs are likely to have frequent contact with regulators in other jurisdictions, seeking legitimate information about the activities of financial institutions. At the same time they may well be subject to "fishing expeditions" conducted by foreign revenue authorities, seeking information on which to develop a case against a suspected tax evader. It is important that the means exist to offer suitable co-operation in both cases, while not breaching confidentiality by responding inappropriately.

One of the most effective ways of achieving this is through the negotiation of mutual legal assistance treaties (MLATs), or, less formally, MoUs, with those jurisdictions that most frequently make requests for assistance. These agreements can specify the circumstances under which a request for assistance will be considered, the nature of assistance that might be provided, and any restrictions that might be placed on the onward transmission of information.

Issues for discussion

What steps can be taken to ensure that regulatory standards are maintained in IFCs in the light of increasing international competition? How can these high standards be presented in a way that will attract sound business while deterring illicit funds?

Confidentiality legislation

Introduction

A feature of many IFCs (and of some other jurisdictions) is the adoption of a statutory basis for financial and commercial confidentiality. Such legislation is often introduced to reassure potential investors that their legitimate right to confidentiality will be respected. It is particularly attractive to those who consider that their domestic rights to confidentiality have been undermined for any reason, such as a hostile and confiscatory government, or corruption within the domestic financial system.

The possible grounds under the Common Law for overriding confidentiality are discussed in Part 3. Unless specific account is taken of these in framing such legislation, it may end up hampering an IFC from being able to take action against criminals, and particularly money launderers, operating within its territory. This situation can be tackled through the introduction of appropriate legislative **gateways.**

Gateways

The purpose of gateways in confidentiality legislation is to establish strictly limited circumstances under which confidentiality may be overridden. These circumstances normally reflect those established in common law by the *Tournier* decision (discussed in Part 3 of this paper). The legislation sets out:

- to whom confidential information may be passed;
- the circumstances under which this is permitted; and
- restrictions on the onward passage of the information.

Most confidentiality legislation permits information to be passed to the supervisory authorities to enable those authorities to carry out their proper functions. An effective anti-money laundering regime must also permit confidential information to be passed to the authorities responsible for combating money laundering where an institution knows or suspects that a transaction in which it is involved relates to the proceeds of crime. It must also permit the disclosure of confidential information to law enforcement agencies investigating money laundering cases, subject to appropriate judicial procedures, such as the obtaining of a court order.

Where the transaction involves other jurisdictions, it is important that it is permissible to

pass the appropriate information to the authorities in those other jurisdictions if this is desirable. It is however possible to restrict the use that may be made of that information. Information to be used for criminal or regulatory purposes may, for instance be passed subject to the proviso that it cannot be used for tax purposes.

Issues for discussion

Where there exists confidentiality legislation, to what extent do Commonwealth members envisage problems in introducing appropriate gateways? What steps can be taken to ensure that the correct balance is struck between the need to maintain confidentiality and the need to tackle money laundering effectively and thoroughly?

Practical issues

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The requirements of the FATF Recommendations discussed in Part III are relevant to IFCs as well as to other jurisdictions. However the international nature of much IFC business makes the practical application of some of the Recommendations more complicated.

Customer identification

Customer identification can be a problem for IFCs as the financial institutions located there will usually never have face-to-face contact with their customers. Indeed, where the financial institution is a "managed bank", or similar booking operation, such contact is non-existent.

In these circumstances reliance must be placed on financial institutions and intermediaries who have actual contact with the clients. Often these will be part of the same financial conglomerate as the local operation. Under these circumstances it is important to ensure that the overseas entities are subject to effective money laundering countermeasures. Where the client contact is through an unrelated intermediary, it is important that the intermediary is subject to adequate regulation, and has itself been subject to identification by the local financial institution. Some of the trade associations involved in international financial business have introduced codes of practice in this area. One example is the Association of International Life Offices (AILO), who recommend a very clear "know your intermediary" approach.

Record keeping

Record keeping also gives rise to concerns. It is important that sufficient information is held locally to allow the reconstruction of transactions. This may well need to include customer identification evidence, or at least sufficient evidence to link the transactions to the customer on whose behalf they were conducted. Where "booking operations" are permitted, it is vital that there is sufficient regulatory control to ensure that a person within the local jurisdiction – for instance the "managing" bank – is answerable for the transactions put through the booking operation if money laundering is involved.

Issues for discussion

Do the special features of IFCs present any particular practical problems for the implementation of the FATF Recommendations? What steps can the regulatory authorities in IFCs take to ensure that adequate anti-money laundering controls are in place in financial institutions without a physical presence within their jurisdiction?

Internal systems and controls

While "managed" banks have little in the way of internal systems, it is important that the business conducted through them is subject to the same

level of surveillance and control as any other transactions. This responsibility must fall upon the managing bank responsible for the managed bank's operations. This responsibility under money laundering legislation will tend to reflect the fiduciary duty owed by the managing bank. Depending upon the terms of the relationship between the two institutions the managing bank may in any case be responsible for the activities of the banks that it manages. The terms of this relationship will, of course, be a matter for the regulatory authorities.