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Centres of Conflict

350 years after the death of the Italian scientist, Galileo Galilei, Pope John Paul II gave an address on behalf of the Catholic Church in which he admitted that errors had been made by the theological advisers who had accused the scientist of heresy following discoveries he made through his telescope about the motion of earth, sun and stars. He was summoned before the Roman Inquisition but none of his persecutors would look through the telescope; it was bad enough that the authority of the church and its view of the world had been challenged. Under threat of torture, the scientist recanted. Will detractors of offshore financial centres one day admit to fundamental misconceptions that closer scrutiny would dispel?

The Caribbean has been particularly successful in providing offshore financial services but not in promoting a positive image. "Banana Republics", a song sung by Jimmy Buffett, was frequently played on the radio back in the 1970s when I lived in the Cayman Islands, the place where I first became acquainted with both Jimmy Buffett and offshore centres; before moving there I wasn't the only one in London who was not sure of Grand Cayman's exact location in the British West Indies. Was it near the Lesser Antilles or in the other direction, nearer Cuba? Jimmy sang about expatriated Americans heading for the tropics who were either fleeing from lovers, running tons of ganja or hiding from the tax man. Maybe all three, but none need neither an offshore centre nor a tropical climate to become a reality. Just like money laundering, terrorist financing, pyramid schemes or other categories of crookedness.

Sunny offshore centres in particular have drawn fire from industrialised countries. Carl Levin, an American senator, reckons that his country alone loses as much as $70 billion a year in taxes because of them. And Tax Justice Network, a not-for-profit group, is stinging in its criticism of offshore centres, claiming that they cause a loss of global tax revenues that exceeds $255 billion a year. Jeffrey Owens, head of fiscal affairs at the Organisation for Economic Co-Operation and Development, has said that offshore asset holdings amount to between $5 trillion and $7 trillion (five times as much as two decades ago) representing around 6-8% of worldwide wealth under management.

Some offshore centres were not created by design. There was no Disney Offshore World blueprint. Jersey in the Channel Islands, off the United Kingdom's coast, was once more famous for its cows and the abundance of buttery, high-fat milk, which they produce. (The neighbouring Bailiwick of Guernsey, where I lived for 3 years, predictably claims that its cows outclass Jersey's.) After the second world war, Jersey's low taxes were a magnet for bank deposits of British expatriates living in former colonies (particularly South Africans). Just like Panama, its tax regime was established long before offshore centres were popular and, in Jersey's case, money became more important than milk to its prosperity. Its standard rate of personal tax (20%) had been set, in fact, by the German occupiers in 1940.

Another example of an accidental offshore centre involves cocktails rather than cows. Back in the 1920s and 1930s socialite Americans would travel to Bermuda and spend part of the summer there. The Astors even had their own railway which linked the ships with their mansion. But for a while it was alcohol, rather than assets, that accounted for

Bermuda's large American presence due to Prohibition back in the US.

While the Cayman Islands went on to become the world's fifth-largest banking centre (about $1.3 trillion in assets) and the British Virgin Islands found fame from corporate formations (700,000 at the last count vs. 70,000 or so in the Cayman Islands – but note Chinese concerns about the BVI in the June, 2005, issue of the OPQ), Bermuda turned from rum to risk and became a giant in the captive insurance and re-insurance fields. Today it is the richest country in the world (closely followed by Luxembourg) with a GDP per person of almost $70,000 compared with $43,500 for America.

Like those already mentioned, a large number of offshore centres are small territories with links to the UK; some of them are still British dependencies. This heritage should not come as a surprise due to Britain's history of empire and today the British Commonwealth has 53 member countries, all of which were once part of the British Empire. Unlike Jersey and Panama, however, some of these offshore centres, including the Cayman Islands, had never even introduced income taxes. As business grew, some of them with shrewd politicians started to diversify beyond banking and began offering additional sophisticated financial services.

Instead of being just labelled as offshore banking centres they were now offshore financial centres, generating very healthy revenues. This presented the UK with an opportunity to make many of its overseas possessions self-sufficient rather than a burden on the British Treasury; filing cabinets replaced scant natural resources. This certainly was the thinking nearly twenty years ago when I moved to the Turks & Caicos Islands in the British West Indies with a remit from the British government to not only establish a regulatory body but actively promote the islands as a finance centre – although in later years promotion was separated from the functions.

So it is not surprising that other countries with small domestic markets, such as Dubai and Kuwait, want to follow suit. The only problem, however, is that membership of the offshore club has become costly and, which I support, more controlled.

Horses for Courses

Henry Ford once said that if he had listened to his customers he would have given them a faster horse. Innovation, as I suggested earlier, has been the key and what those offshore centres have done is to introduce new products which have broadened the horizon of financial opportunities.

The onshore finance centres should see their offshore counterparts as part of a global financial framework in which the role of each complements, and not necessarily competes with, the other. Both have their respective strengths and weaknesses so there is no need, in other words, to have a bailiwick-bashing contest to prove your cow, or product, is superior.

In any event, there's no doubt that the line drawn between what constitutes either an offshore or onshore centre has become less visible to the eye in recent years. Geography does not necessarily have any bearing on the matter.

The Global Financial Centres Index (with additional data from PriceWaterhouseCoopers) produced findings in March that found London, then New York, as the only truly global financial centres, with Hong Kong third followed by Singapore and then Zurich. The GFCI ranked London five points ahead of New York after considering five areas of competitiveness: people, business environment, market access, infrastructure and general competitiveness.

It can be argued that London's edge is linked to both its history of international trade and the adage that there is no substitute for experience. The UK's relatively small home market made foreign trading inevitable for ambitious entrepreneurs and as long ago as 1773, the year tea was tossed into Boston Harbour by American colonists, Josiah Wedgwood sold Catherine the Great of Russia a 954-piece dinner service. Almost one hundred years before that sale financial expertise had been imported when William of Orange assumed the English throne in 1668. The Dutch financiers he brought from Holland would be instrumental in the City of London's future success.

But the main attraction, when comparisons are made with New York, remains the regulatory regime and not London's history. The rules-based approach to corporate governance in the US (see the March issue of the OPQ) has produced a greater degree of complexity in more ways than one. Conversely, the less daunting regulatory structure under which London operates is conducive to attracting international business; American critics of their own system have voiced concerns that they have been put at a competitive disadvantage. It is true that detailed rules make the auditor's job easier to control clients, but it also makes it easier for people to work out precisely what to do to get around them.

The Chairman of the International Accounting Standards Board commenting on the US system in 2003 had this to say: "We have principles, they have rules. They have principles too, but they issue much more guidance. The minute you start going into the detail you make it easy to bypass the standard". A year earlier the Chairman of America's Financial Accounting Standards Board acknowledged that British accountants worked on the principle that a company's accounts should reflect a true and fair view of its underlying economic position and that this must take precedence over detailed rules.

Nothing illustrates the divide quite like Enron (see also the September, 1996, issue of the OPQ), whose accountants used "mark-to-marketing" accounting (which books earnings on assumed future income) and created "off-balance sheet" loans which did not disclose to shareholders just how much debt lay (apologies to Ken) behind the income. Then the company privately pledged unissued stock as collateral for those loans instead of recording a charge against its assets.

Tim Bush, a director of Hermes UK Focus Fund, speaking in January at a roundtable meeting organised by the Institute of Chartered Accountants in England and Wales, observed that what was done by Enron would not be permitted under UK Company law but acknowledged that Enron's accounting "had passed the tests of US Generally Accepted Accounting Principles on these things". During my tenure in the Turks & Caicos Islands I was required to review sets of corporate accounts submitted by US applicants as part of the regulatory licensing process (particularly in the case of insurance) and appreciate Mr. Bush's observation.

But there is hope. Last month Ben Bernanke, chairman of the US Federal Reserve, called for US financial regulators to study the UK supervisory system and learn from its principles-based approach.

I would like to add one further – and often relevant – issue which is allied to the differing approaches to accounting. It is the relationship between director and shareholder. Lady Barbara Judge, deputy chairman of the Financial Reporting Council, the UK's accounting regulator, and who was also once the youngest ever commissioner of the US Securities and Exchange Commission, put it this way: "Directors are used to having their own unfettered way in the US, whereas in the UK there is greater pressure from shareholders".

Pressure is needed – especially when shareholders are "Enronised" by not being told, firstly, about the exact amount of company debt vs. income and, secondly, that unissued stock has been pledged to support it. As the Financial Reporting Council's Chairman, Sir Christopher Hogg, put it: "UK shareholders have enviable rights compared with the US. The long-term benefits of this are clear".

Once one accepts that a director is acting in a fiduciary capacity on behalf of the shareholders, his obligations (being similar to those of a trustee) will be clear and should guide his actions accordingly. This, surely, is a natural blend of common law and common sense.

Look Through the Telescope

Regulations aside, one thing is certain: any rivalry between London and New York has little to do with the parallel international business that is managed offshore. So much of that offshore business is, in fact, wholesale and not retail. Take, for example, that approximately $1.3 trillion on deposit in banks in the Cayman Islands; 93% of those deposits are interbank bookings and not personal or corporate accounts.

The OECD assertion that offshore centres divert taxes away from developed countries should not be taken at face value either. Consider the situation in the case of America where, because it taxes very little of the money held in its banks by non-resident foreigners, foreign deposits total $2.5 trillion. Compare this with Switzerland where similar deposits total well under half that amount. The UK has gone one step further. It has drawn residents from overseas to its shores like a moth to a flame because it is perhaps the biggest personal-tax haven of all. People living there, but who can claim domicile elsewhere, are classified as resident non-domiciles and as such they do not have to pay tax on any external income. The UK approach in this instance is similar to the territorial tax system found in Panama.

The territorial tax system (only what's earned in the country is taxed there) definitely has financial advantages for companies, not just individuals, and it is surprising for some to learn that it is applied by the large majority of OECD countries. Even for companies that are taxed on their worldwide profits, sending and keeping money offshore can be a good idea because countries that do tax worldwide profits only claim the taxes on the foreign portion once it is repatriated.

Consider either a trust or foundation established offshore where, subject to circumstances, it is often possible to defer any taxes as long as the assets remain offshore. Both the trust and the foundation under the right conditions have the added attraction of being an effective means of protecting assets against claims as well as not only avoiding probate, but enabling wealth to be passed on to heirs without the payment of inheritance taxes.

In some jurisdictions (such as Switzerland, Luxembourg and Singapore) not paying taxes owed to foreign authorities is not a crime. In Panama, for example, tax offences are civil, not criminal, and although it is a party to the Inter-American Convention on Mutual Assistance in Criminal Matters, Panama (along with Jamaica) has reserved the right to decline assistance unless the alleged offence is also crime in Panama.

So things are not always black and white and a lot has changed since I first heard the song, Banana Republics, nearly 30 years ago. Today, however, the first prize in the banana republic stakes should go to my former home, the faltering Republic of Zimbabwe (or should that be Grimbabwe?) where recently the secretary-general of the country's Progressive Teachers Union estimated that graduate teachers were earning "four and a half bananas a day".

Things change and appreciating that is invaluable in the offshore business, especially when planning your finances. It is also useful to sometimes question convention and not refuse to look through telescopes.

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