Offshore Financial Centers: Recent Evolution and Likely Future Trends

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Introduction

The International Financial Centers are urban locations dispersed all over the geography of the planet. Their main economic activity is the supply of international financial services by multinational commercial banks and other large-scale agents. The main services provided include the reception of deposits, different forms of credit to enterprises and governments, and many other more specialized activities like interbank transferences, currency exchange, swaps of currencies and interest rates, trading of futures contracts, etc. They play a role of great importance for the operation of the global financial system.

As a response to the financial crisis of 2007-2009, and to the marked global economic deceleration that ensued, in 2009 governments and financial authorities of the more developed countries agreed to design and take to execution a strategy to overcome the crisis.

Negotiations to define what actions to conduct as well as the responsibilities that correspond to different multilateral organizations like the World Bank (WB) and the International Monetary Fund (IMF) took place during the first months of 2009, with the direct participation of the governments of the 20 major economies of

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the planet, the group called "G20". On April 2, 2009, there was a meeting of the Heads of Government and Chiefs of State of the G20 members in London, and an official declaration was made public at the end. It contained the main actions to conduct and the way the responsibilities to pursuit their execution will be distributed.

The initiatives of the G20 members included using financial resources in the order of 1,1 trillion U.S. dollars to support financial organizations with urgent needs of liquidity or capitalization, and to impulse the recovery of growth. These were, no doubt, extraordinary measures by the order of magnitude of the resources involved and by the multilateral character of the coordination required something without precedent. Nevertheless, there was consensus on the urgency of their need to palliate the effects of the crisis, and to reactivate the flow of credit to the economy.

In the official communiqué of the meeting, the participants attributed the causes of the crisis to faulty regulation and supervision of the financial sector, particularly in the banking sector. Consequently, the most relevant proposals were oriented towards the revamp of the regulatory frame and the supervision mechanisms to support the recovery of the financial sector. With such an intention, the members started working in co-ordination to make sure that the reforms to the national regulatory systems (or regional, as in the case of countries that share the same financial currency and the same institutions) would be robust.

The intention was to obtain a greater integration and transparency in the regulation and supervision of the financial markets, to stabilize the financial cycle, to reduce the dependency of economic agents from risky sources of financing and to discourage the taking of financial positions with excessive risks. Among the most relevant aspects of the proposal, there was the statement that regulators and national supervisors are responsible to protect to the consumers and investors, to support market discipline, to avoid adverse impacts on other countries, to reduce the scope for regulatory arbitration, to support competition and to look for a continuous adaptation of the regulatory framework to the keep-up with the fast pace of the innovations introduced by market participants.

At a more specific level, the official declaration of the G20 emphasized the introduction of new regulations to examine the operation of hedge funds, as well as "vigorous measures" against those countries classified as "fiscal paradises", that would be publicly identified and subject to sanctions if they did not accept to share fiscal information with the authorities of other countries.

Of the reading of the official notice issued when finalizing the meeting of the G20 it was very clear that the intention of the signatory countries was to apply sanctions to those jurisdictions considered like fiscal paradises in defense of their public finances and their financial systems. Also, their decision explicitly aimed to conclude the era of “banking secrecy”.

That same day, April 2nd, 2009, the Organization for Economic Cooperation and Development (the OECD) announced the results of an evaluation made to a group of jurisdictions it follows to measure the fulfillment of internationally accepted standards of fiscal transparency. The jurisdictions included in the list were classified according to their degree of advancement in the fulfillment of acquired commitments to negotiate agreements of fiscal exchange of information.

The diversity of the matters that the G20 proposed to reform, and the additional complexity derived from the different points of view that existed between Member States, suggested that the new regulations and announced measures would take time. However, the forcefulness with which the intentions of the G20 members were expressed makes it likely that they will be made effective in the non-distant future.

In all the official declarations, emphasis was put on the need to find an appropriate balance between new national and supranational regulatory frameworks to reduce the risks of financial globalization and, at the same time, to guarantee the freedom required to operate financial centers. Within that context, the danger consists in getting to adopt measures that may dampen economic recovery by discouraging the flow of credit to the real economy.

Within that context, improving the understanding of the workings and functionalities of Financial Offshore Centers becomes a subject which, having its own interest, also has a general interest as part of the challenging process to overcome the extremely costly consequences of the recent financial crisis.

International Financial Centers and Offshore Financial Centers

Sociological, political, and even military factors have been present in the surge of International Financial Centers (IFCs), and their evolution has gone through periods of relative stability, but also of great turbulence. There are good economic reasons that justify their existence, be it in terms of an international services specialization, or in terms of the economies of scale and scope that can be achieved in the different types of services they offer.

It is very important to analyze the conditions through which the international fiduciary system is currently transiting through an extraordinary period, faced with a number of changes that have resulted from the complex circumstances associated to the 2007-2009 financial crisis.

The permanence and growth of the activities carried out by the IFCs and the Offshore Financial Centers (OFCs) will depend, in a good measure, on the design and execution of the public policies resulting from coordinated international efforts motivated by the crisis to redefine the architecture and rules of the international financial system.

Among other several interesting features, IFCs and OFCs have the potential to create a vast amount of specialized and well remunerated jobs for activities directly linked to the financial intermediation process and complementary services. They represent a significant fiscal income source for the locations that host them, and have favored the accumulation of wealth of cities and countries in which they have surged.

These benefits become much more evident in the cases of major IFCs, such as London, New York, Tokyo, Frankfurt and Paris, although they are also quite important for other places in developed and developing countries. Historically, the rise of the IFCs was closely related to the productive and commercialization activities carried out in a specific location.

Along the global economy's transition towards its post-industrial stage of development, in which new laws for competition rule, a considerable number of IFC/OFC locations with different functional focus, size and potential have risen and compete with each other. The competition takes place mainly on the base of products and services aimed at particular markets, but also in terms of their continuous efforts to innovate and become more productive all the time.

From an extensive review of the literature on the conceptual elements associated to the IFCs/OFCs it is possible to identify numerous common traits to all of them. In particular, there is a generalized consensus regarding the fact that IFCs/OFCs generate a number of indirect benefits to the host countries, some of them very substantial. The most frequently cited arguments can be summarized as follows:

1. Optimization of distributional efficiency: to host an IFC reduces the probability that monopolies or monopsonies arise in the local financial industry; its presence promotes savings, as well as the integration of the domestic economy with other more efficient regional markets, and/or with the global market. An optimal allocation of financial resources at a regional and even global scope is achieved thanks to them.
2. Increase the size of the high-end local jobs segment: the IFCs give impulse to the development of a domestic financial industry and other sophisticated services that are closely associated like, for example, the professional services of lawyers, accountants, printing and different types of transportation. That development generates new opportunities for well remunerated jobs that represent the possibility of "Career Plans" for local citizens. Also, the economic activity generated by the above mentioned industries affects other sectors and brings about a beneficial multiplicative effect for the economy as a whole.
3. Tax Generation: the IFCs' activity generates additional fiscal income for host governments. That fiscal income includes taxes on the income of individuals employed by the financial services industry and related activities, fees and tariffs for the registration of foreign financial institutions, rights on the transference of titles, etc. Other diverse types of taxes frequently generated are, for example, real estate transactions and capital gains, in addition to the previously mentioned.
4. They promote the internationalization of the local economy: the location of IFCs attracts foreign investments to the host country, be it under the form of 'joint ventures' or other diverse forms. It also accelerates the smooth flow of relevant information on financial, commercial and industrial aspects originated beyond the borders of the country. Thus, the arrival of relatively abundant foreign capital and the flow of international information results in the modernization of the local economy.
5. Increase of the financial activities of Multinational Corporations (MNCs): IFCs/OFCs are frequently hosts of commercial and industrial conglomerates' headquarters; they also frequently host the financial subsidiaries of MNCs, given their favorable fiscal and regulatory

environment. For example, the so-called ‘captive insurance companies’ of MNCs are generally located in OFCs to maximize their financial flexibility.

The international hierarchy recognized to different IFCs has to do, mainly, with their capacity to represent a safe option to protect investments, as well as with their role as a source of financing. Their prestige also depends on the quality, solidity and visibility of the institutions established in each case.

It is possible to carry out a measurement of the specific weight that the economic activity of the financial sector in a country represents through different approaches like, for example, the value of the exports of financial services, the level of development of their stock market, the size of the banks established, the presence of foreign banks, the presence of their own banks abroad, the absolute and relative amount of foreign deposits received, credits granted to foreigners, etc. The possibility of using one or several of those measurement tools is subject to the availability of frequently incomplete and hardly homogeneous information.

One can look at the degree of freedom to perform their activity as a continuum in which, at one extreme, practically no restrictions exist to the operation of financial intermediaries and, at the other extreme, nationalization and State control of the institutions prevails.

The More Traditional International Financial Centers

The origins of the first IFCs took place as a result of commercial activities and/or the presence of important “nodes” (hubs) of transportation (in particular, the ports oriented to marine transportation of commercial effects), but also responded to factors like the existence of political stability, and the presence of solid monetary or financial institutions.

In the years that followed the 2nd World War, London and Tokyo satisfied those characteristics totally, as well as Singapore and Hong Kong. Of the three, London achieved a major expansion and positioned itself as one of the two largest and more diversified IFCs in the world. Since its early times, New York fulfilled the majority of the requirements, but it did not still operate like a “node” of transport until the 20th century, when the sheer size and high sophistication of its capital markets converted it into the other paradigmatic IFC.

Even before the establishment of the Bundesbank, Frankfurt stood out more than other German places like Dusseldorf and Hamburg and, in more the recent times, its leadership was strengthened when it was selected as the location for the new European Central bank, from where the monetary policy for all the Member States of the European Monetary Union is conducted. Additionally, the most important system of liquidations and payments known like TARGET, operates from Frankfurt.

The Euromarkets and the surge of the Offshore Financial Centers

During the early 1960s the vast majority of the national financial systems was quite refractory to performing transactions with foreigners. Only New York, and to a lesser extent London, had reached a truly international category. Nevertheless, the transformations of the following years created the conditions for the sprouting of the market for 'eurodollars'.

By 1958 the dispositions contained in the Bretton Woods Agreement, signed since July of 1944, became fully effective. Consequently, the dollar became the pillar of the international monetary system, and the majority of the currencies returned to free convertibility. At that time, some European banks began to operate in dollars (Levich 1990; Cassard 1994).

The chronic deficit of the United States balance of payments during the 1940s, and the efforts aimed to the reconstruction of Europe already had produced a relative abundance of dollars in the international markets. During the same period, due to the economic importance of the U.S. dollar, the quote of practically all the commodities traded in the international market was expressed in dollars. Therefore, the brokers frequently received payments and realized deposits in that currency outside the territory of the United States.

The above facts explain why it became more frequent to observe banks from Canada, Switzerland and Great Britain accept deposits in U.S. dollars originated from foreign trade and foreign investment transactions. At first, those deposits were placed in U.S. money and capital market instruments through correspondents in New York but, by the mid 1950s, some foreign banks that received dollar deposits decided to use them to finance foreign trade transactions or other projects, from which they obtained an attractive yield. This completed the circuit of deposits-loans in U.S. dollars taking place out of the territory of the United States and created a wholly new market know as the 'Eurodollar' market.

An anecdotic factor that had an influence in the surge and consolidation of the Eurodollar market was the supply of dollars owned by the governments of the U.S.S.R., China, and of other Eastern European countries. During the Cold War years, those countries resisted to deposit the dollars generated from their exports and used for diverse commercial transactions (or with political or 'intelligence' purposes) in accounts in banks based inside the United States.

Thus, instead of incurring the risk of a confiscation, the Russians, for example, deposited their dollars in London and Paris in banks affiliated with banks property of the Russian state. One of those banks, located in Paris, the Banque Commerciale pour l'Europe du Nord, used the cable direction "EUROBANK", term that from those times onwards was associated to the activity of receiving deposits and granting loans in a foreign currency.

However, the list of possible factors that gave impulse to the surge of the OFCs is extensive. Some of the likely influences were, among others:

- The regulations imposed by some developed countries (the United States and the United Kingdom)[2] by which lending to foreigners in local currency was prohibited[3];
- Ceilings to the interest rates that were paid in the domestic market of the United States (the so-called Regulation 'Q')[4];

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[2] The 'Interest Equalization Tax' (IET), introduced in 1963, was the first measure implemented by the United States to control its chronic Balance of Payments disequilibrium, due to the foreign investment and loans capital flows towards overseas territories. The IET established a retention at the source over interests on loans granted by U.S. residents to foreigners.

[3] As their short and medium term compromises grew, and their gold reserves declined, the U.S. authorities introduced a 'Voluntary Foreign Credit Restraint' in February 1965, with the intention to reduce the flow of capital towards foreign countries. Beginning in 1968 the character of that restraint became obligatory.

- The limited size of the domestic market of several countries to satisfy the needs of large projects, or of multinationals based in those countries.
- The establishment of capital controls to reinforce industrialized countries monetary policy effects.
- The elimination in 1958 of the currency exchange rate restrictions in Western Europe.
- The desire of U.S. banks to carry out business in overseas territories, propelled by the Glass-Steagall Act, that prohibited commercial banks to participate in the investment banking industry (and vice versa).

As a result of such diverse economic forces at work, at first, the International Financial System began working under the new logic of the Eurodollars (more so, because the dollar was the axis of the Bretton Woods Agreement). But, a few years later, there was a surge of other ‘Eurocurrencies’ to include, besides the North American dollar, the German mark (Euromark), the Swiss franc (Euro-Swiss Franc), the pound sterling (Europound), etc.

In particular, the place of London, actively supported by the Bank of England, took advantage of the opportunities associated with the sprouting of the Euromarkets. The activities of the London banks (and foreign banks present there) specialized in intermediation services for foreign agents. Thus, after the difficult challenges it faced during World War II, London recovered its important standing in the international the financial system[5].

As of the first years of the 1970s the geographic location of the Euromarkets had expanded beyond the territory of Western Europe. The banks at first, and the insurance companies and brokerage houses some time later, began to establish subsidiaries in numerous jurisdictions within the Caribbean, Latin America and

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[4] The Regulation ‘Q’ was introduced during the 1930s top put a ceiling to the interests paid by deposits made in the U.S. domestic market, thus representing an incentive to search for more profitable returns overseas.

[5] During the 1950s, but mainly during the 1960s, the London based financial industry surged notably, in spite of the weakness of the sterling pound that was devalued in November of 1967.

Southeast Asia regions. Those jurisdictions became what nowadays we know as "Offshore Financial Centers"[6].

That concatenation of cause-effect relationships leads to the conclusion that the OFCs and the market for Eurocurrencies share a common history, since the former rose as a result of the geographic expansion of the latter. In a sense, both embodied an answer of the multinational banks and corporations to the attempts of the governments of several industrialized countries to control the international flows of capital exiting their jurisdictions by means of regulation. Their original intention was to reinforce their control over capital flows to achieve greater effectiveness with their monetary policy measures, but the markets, unexpectedly, reoriented deposits and demand of financing towards multinational banks established in different the OFCs.

In most cases, the new OFCs were small countries and stand-alone cities that did not face great difficulties to attract international banking institutions, and obtained substantial benefits for their domestic economy in terms of the creation of high-salary employments, the contribution to their fiscal income, the development of infrastructure and the development of other sectors indirectly associated with the activity and operations of the OFC.

From a strategic analysis perspective, the surge of the Euromarkets, the progress of communications technology and the transformations to the regulations of the main industrialized countries acted to reduce the "barriers to entrance" to the industry of international financial intermediation. To create the necessary conditions to constitute itself like a OFC, an interested country only had to create a favorable regulatory frame, give a decided impulse to its communications infrastructure, and introduce some innovations in its operations.

Some initiatives were more successful than others; for example, in some countries offshore banking accounts were created especially for foreign financial institutions, like the Asian Currency Units (ACU) in Singapore, the Deposit Taking Companies (DTC) in Hong Kong, or the Offshore Banking Units (OBU) in Bahrein and Manila.

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[6]The Bank for International Settlements defines an "offshore" center when the proportion of financial transactions with respect to its GDP is more than three times.

London was the first place that operated with all the characteristics of an OFC. Later, many more cities, in all geographic areas of the planet, reproduced the model, but always introduced some variations. Although the functions that each OFC carries out as part of the international financial system are not the same, their operating model and their development process have been relatively similar.

Implications for the Offshore Financial Centers of the G20 Efforts to Achieve Economic Recovery

Within the objectives of The Global Plan for Recovery and Reform, presented at the G20 meeting, those which are focused to the financial system, regulation of the financial sector, global trade and investment, are the ones that will be affecting directly the International and Offshore Financial Centers.

Among the initiatives presented by the G20 members to deal with the challenges ahead, there was an explicit mention to the fact that the Financial Stability Forum should be expanded, given a broadened mandate to promote financial stability, and re-established with a stronger institutional basis and enhanced capacity as the Financial Stability Board (FSB).

The FSB will:

- Assess vulnerabilities affecting the financial system, identify and oversee action needed to address them;
- Promote co-ordination and information exchange among authorities responsible for financial stability;
- Monitor and advise on market developments and their implications for regulatory policy;
- Advise on and monitor best practice in meeting regulatory standards;
- Undertake joint strategic reviews of the policy development work of the international Standard Setting Bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps;
- Set guidelines for, and support the establishment, functioning of, and participation in, supervisory colleges, including through ongoing identification of the most systemically important cross-border firms;
- Support contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and

- Collaborate with the IMF to conduct Early Warning Exercises to identify and report to the IMFC and the G20 Finance Ministers and Central Bank Governors on the build-up of macroeconomic and financial risks and the actions needed to address them.

In terms of the scope of the new regulatory framework, it was agreed that all systemically important financial institutions, markets, and instruments will be subject to an appropriate degree of regulation and oversight. In particular:

- The regulatory systems will be amended to ensure that authorities are able to identify and take account of macro-prudential risks across the financial system including in the case of regulated banks, shadow banks, and private pools of capital to limit the build-up of systemic risk. Large and complex financial institutions require particularly careful oversight given their systemic importance;
- It will be ensured that the national regulators possess the powers for gathering relevant information on all material financial institutions, markets, and instruments in order to assess the potential for their failure or severe stress to contribute to systemic risk. This will be done in close coordination at international level in order to achieve as much consistency as possible across jurisdictions;
- In order to prevent regulatory arbitrage, the IMF and the FSB will produce guidelines for national authorities to assess whether a financial institution, market, or an instrument is systemically important by the next meeting of our Finance Ministers and Central Bank Governors. These guidelines should focus on what institutions do rather than their legal form;
- Hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis, including their leverage, necessary for assessment of the systemic risks that they pose individually or collectively. Where appropriate, registration should be subject to a minimum size. They will be subject to oversight to ensure that they have adequate risk management.
- Supervisors should require that institutions which have hedge funds as their counterparties have effective risk management practices and systems. This should include mechanisms to monitor the funds' leverage and set limits for single counterparty exposures;

- Standardization and resilience of credit derivatives markets will be promoted, in particular through the establishment of central clearing counterparties subject to effective regulation and supervision.

More specific guidelines for Tax havens and non-cooperative jurisdictions were clearly drawn under the belief that it is essential to protect public finances and international standards against the risks posed by non-cooperative jurisdictions.

The call on countries to adopt the international standard for information exchange was endorsed by the G20 in 2004 and reflected in the U.N. Model Tax Convention. The OECD has today published a list of countries assessed by the Global Forum against the international standard for exchange of information.

Actions will be taken against those jurisdictions which do not meet international standards in relation to tax transparency. To this end it was agreed to develop a toolbox of effective counter measures for countries to consider, such as:

- Increased disclosure requirements on the part of taxpayers and financial institutions to report transactions involving non-cooperative jurisdictions;
- Withholding taxes in respect of a wide variety of payments;
- Denying deductions in respect of expense payments to payees resident in a non-cooperative jurisdiction;
- Reviewing tax treaty policy;
- Asking international institutions and regional development banks to review their investment policies; and,
- Giving extra weight to the principles of tax transparency and information exchange when designing bilateral aid programs.

The IMF and the FSB in cooperation with international standard-setters were designated to provide an assessment of implementation of these rules by relevant jurisdictions, building on existing FSAPs, wherever they exist.

It cannot be disregarded that probably the most powerful reason why OFCs have thrived in recent decades is their franc disposition towards bank secrecy. The principle of anonymity of bank account holders as well as the secrecy on the nature, frequency and magnitude of the transactions they perform is something that OFC's clients value much and are unwilling to lose.

It is true that, in granting secrecy to any account-holder, financial intermediaries become a potential smoke-curtain behind which non-legal transactions can take place. However, OFCs' challenge is, precisely, to guarantee such practices do not occur. This is a matter of the utmost ethical importance from a professional perspective, although a very complex challenge in operational terms at the same time.

One of the areas where OFCs are experiencing more international pressure as part of the recent initiatives is in the area of tax-shielding related transactions.

Concluding Remarks

As the G20 initiatives become effective, the OFCs will be more regulated and more closely monitored within a framework of information disclosure, such that the flow of funds and their allocation can be easily tracked.

The enforcement of the new rules that will derive from G20 initiatives and other unilateral initiatives from countries severely affected by tax-evasion by their citizens is justified in more than one sense. However, it is likely to have serious effects on the longer-term viability of the OFCs.

The risk, as usual in the financial industry, is to find the right amount between too much and too little regulation. In the process of developing the new framework, authorities must not disregard the important economic functions that the OFCs perform for the rest of the international financial system.

By reducing the costs of transaction and bureaucratic red-tape, the functioning of the OFCs can contribute significantly to the world's economic recovery. Also, the role that OFCs can play if they specialize in dealing with "toxic assets" for the rest of the world may represent a long-awaited escape valve that will conduct to more liquidity and objective valuation of those securities.

International financial centers are constantly battling against new initiatives and threats from different economic and financial bodies throughout the world. The more financial industry rules and regulations that are implemented by the most developed countries, the better offshore financial centers will do. Bureaucracy is like oxygen to OFCs, the more there is, the more the opportunities that exist to provide safe havens for those fleeing it.

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