2019

The Evolution of Offshore: From Tax Havens to IFCs

Andrew P. Morriss

Charlotte Ku

The Evolution Of Offshore: From Tax Havens To IFCs

 

By Andrew P. Morriss, Dean of the School of Innovation and Professor at the Bush School of Government & Public Service & Charlotte Ku, Professor of Law, Texas A&M University

OVER THE PAST 70 YEARS, many smaller jurisdictions have evolved into international financial centres (IFCs). Although different in their historic origins and in the financial products and services they offer, IFCs share a common development path. Understanding that evolution can shed light on what the next decade is likely to bring.

Not Being Somewhere Else

Before World War I, the international financial order was built around the gold standard; several relatively free trade zones (the British Empire, the French colonial empire, the American zone of influence) and multinational businesses, including banks serving international businesses such as First National City Bank (the forerunner of Citibank), consumer product companies such as Unilever, and natural resource producers such as Royal Dutch/Shell. By the end of World War II, that financial order was shattered not only by the war but by Nazi and Soviet efforts at autarky, tariff wars, the Great Depression, and the liquidation of UK overseas assets to pay for both world wars.

The new global financial order – constructed under the Bretton Woods framework established in 1944 – poured millions in dollars into the world economy through the Marshall Plan and US military spending abroad. The United States enjoyed an export boom as countries devastated by the war bought capital goods to rebuild their economies. Decolonisation prompted reverse migration from Britain's newly independent colonies, with returning ex-colonials seeking British banking and financial services inside the sterling zone, but outside the UK's high tax regimes. This demand grew in the 1960s as top marginal tax rates soared in most developing economies and the United States began efforts to restrain foreign access to US capital markets through voluntary restraints and mandatory methods such as the Interest Equalisation Tax. The Eurodollar market resulted – based in the City of London but taking advantage of connections to jurisdictions associated with the UK, but not in the UK proper.

> "Legal, accounting, and other financial services industries grew in these financial centres as they developed."

This situation created opportunities for jurisdictions that had historic ties to major economies, but were not subject to their laws. Such jurisdictions had rudimentary financial infrastructure in place to service industries such as tourism in the Bahamas or the oil refining industry in Curaçao. These included the Channel Islands and the Isle of Man in Europe, Hong Kong in Asia, Bermuda and other British and Dutch Caribbean territories in the Americas. As semi-autonomous units, these territories were not subject to the domestic banking reserve requirements that UK and US banks faced at home and lacked high direct taxation rates. The contemporaneous labelling of these jurisdictions as "tax havens" (in what was originally a benign use of the term) captures their original role as havens from onerous legal requirements imposed elsewhere.

Close to major financial markets, and with sufficient communication infrastructure, jurisdictions such as Jersey and the Bahamas established bank-oriented financial structures that legally located transactions outside UK and US domestic regulation. Jurisdictions such as Curaçao took advantage of tax treaties like the 1955 extension of the US. -Netherlands treaty to overseas Dutch territories to create similar opportunities. Others such as the Cayman Islands explicitly set out to develop financial industries with the encouragement of UK colonial officials looking for long-term development strategies. This first stage of development was characterised by jurisdictions using their historic statuses and autonomy as, in effect, a walled garden into which economic activity could be attracted by offering protection from other jurisdictions' taxes and regulations.

The erosion and then collapse of the Bretton Woods framework in 1971 created further opportunity. Britain's abrupt shrinkage of the sterling area in 1972 and the termination of capital and exchange controls in 1979 created demand for ways to hedge the expanded currency risks of floating exchange rates. Domestic financial systems sought to limit the exposure of financial institutions as exemplified by the collapses of the German Herstatt Bank and the US Franklin National Bank in 1974. In the meantime, steps to rebuild the international financial order, such as the 1988 Basel Accord, had little immediate impact on offshore jurisdictions. International focus was on the risks of expanded cross-jurisdictional banking, cross-border consumer investment funds (as seen in the collapse of Bernard Cornfield's Investors

> "The investments in local legal and regulatory infrastructure were key to the emergence of these jurisdictions as places where value was added to transactions and suitcases of cash were no longer welcome."

Overseas Service), and the defaults and restructurings resulting from the massive expansion of international lending to developing countries in the 1970s.

Climbing The Value Chain

Legal, accounting, and other financial services industries grew in these financial centres as they developed. The Caymans went from no lawyers at all in 1960 to attracting Oxbridge graduates working at City firms by the early 1970s—no doubt aided by the dismal economic conditions, power cuts, and strikes that plagued Britain during that time. Armed with this talent, these small island financial centres began to explore moving up the value chain in the 1970s and 1980s. They sought to increase profits by growing both the volume of transactions and the proportion of each transaction occurring in their jurisdictions. Thus, began the transformation of these centres from offshore regulatory and tax havens into centres where local law added value to transactions.

Offshore insurance markets provide an example. Bermuda developed a role as an offshore jurisdiction in the 1930s. In the early 1960s, US lawyer Fred Reiss chose Bermuda to pioneer the captive insurance industry, sowing the seeds for more complex transactions later. The Cayman Islands persuaded Harvard's hospital system to locate its medical malpractice captive there by passing an insurance law and taking the first steps to regulate offshore insurance.

The funds industry sought similar legal infrastructure in the 1980s, leading these jurisdictions to pass laws and expand regulatory infrastructure to support them. These laws enabled new types of transactions and screened out bad actors, making these jurisdictions attractive to legitimate business.

As an example, the Bahamas passed almost 20 major financial-services-related statutes in the 1980s and 1990s. These established or revised legal frameworks to regulate banking, companies and other business entities, funds, insurance, and trusts, and created the infrastructure to collaborate with international law enforcement efforts to stop money laundering and corruption. Other offshore jurisdictions undertook similarly extensive expansions of their legal infrastructure.

Offshore jurisdictions also expanded their regulatory infrastructure, establishing independent regulatory bodies outside of government, and separating promotional from regulatory efforts. Guernsey adopted this strategy early and created the Guernsey Financial Services Commission in 1987. Others soon followed. Expertise for these new regulatory bodies drew on the British colonial and Commonwealth practice of recruiting needed experts from outside a jurisdiction. This provided access to internationally recognised and trusted personnel. For example, among the six members of the first board of the Cayman Islands Monetary Authority (established 1997) were a UK Financial Services Authority employee, a Canadian banking supervisor, and a retired senior partner of KPMG Peat Marwick; three of the six had received honours from the UK government. Jurisdictions also started case-by-case information exchanges with other jurisdictions through treaties (e.g. the Mutual Legal Assistance Treaty negotiated in the 1980s between the UK on behalf of Cayman and the United States).

The investments in local legal and regulatory infrastructure were key to the emergence of these jurisdictions as places where value was added to transactions and suitcases of cash were no longer welcome. In contrast to simply enabling avoidance of onshore regulations or taxes, offshore statutes now provided for varied and higher quality business structures than those available onshore. For example, Guernsey pioneered the protected cell company structure for insurance in 1997. That legislation quickly spread to other jurisdictions and also began to be used for funds. Jersey's 1984 substantive (and not simply procedural) Trust Law created a statutory framework that increased certainty of outcomes, making trusts more attractive to non-common law jurisdiction clients. This idea also spread to other offshore financial centres.

By the end of the 1990s, successful offshore jurisdictions offered distinctive value to their transactions and became factors in a more complex international regulatory environment. Onshore jurisdictions became concerned that offshore competition was eroding their fiscal autonomy and diminishing their regulatory efforts. Both individually and collectively by using the OECD to coordinate, onshore jurisdictions sought controls over what they labelled "harmful tax practices" in 1998.

> "The next generation of international regulations will add to pressures to homogenise IFCs' offerings and to raise their costs of doing business."

The Expansion Of International Regulatory Efforts

Initially focused on the erosion of the tax base and money laundering of the proceeds of crime, international regulatory efforts turned to security concerns after 9/11. This enhanced regulatory regime required IFCs to continue adding to their legal infrastructure to compete for business. For example, the Bahamas passed more than 10 major statutes to address new international requirements after 2001 in addition to updating existing laws. IFCs also had to commit resources to interacting with new regulatory regimes, such as MoneyVal for European jurisdictions or the Caribbean Financial Action Task Force for Caribbean jurisdictions, and with private standard-setters like the International Organization of Securities Commissions and the International Association of Insurance Supervisors. Jurisdictions were incurring new expenses without receiving comparable benefits or advantage in return.

The transformation of obligations from the friction-reducing provisions in bilateral tax and investment treaties to friction-increasing provisions imposed as part of an international regulatory regime is one of the major differences between the pre- and post-2001 worlds. Added to the new costs of post-9/11 international regulation is the more organised anti-competitive measures from onshore competitors. Blacklists of "non-cooperative jurisdictions" by individual governments and the European Union are an important example. These blacklists are rarely developed openly, lack clear criteria, and, in the EU's case, appear to be applied preferentially by excluding EU members whose practices are hard to distinguish from blacklisted non-members. The United States directly imposed costs on other jurisdictions by leveraging its position in the international financial system to conclude agreements with 113 countries and jurisdictions requiring foreign financial institutions to report on assets held by U.S. taxpayers under the Foreign Account Tax Compliance Act (FATCA).

The Outlook For The 2020s

The landscape faced by IFCs in the 2020s is demanding. Not only must they continue developing new products to maintain competitiveness, but they will have to meet new international requirements including a growing onshore interest in the establishment of public beneficial ownership registers. The task is sufficiently difficult that no jurisdiction, onshore or offshore, has yet produced an accurate and public register. The next generation of international regulations will add to pressures to homogenise IFCs' offerings and to raise their costs of doing business. This emerging regulatory regime will require concerted efforts by IFCs collectively to preserve their autonomy and prevent their onshore competitors from regulating them out of business. While IFCs have been successful innovators individually, collaborating with each other is in its infancy. Expanding their ability to collaborate and compete is the next challenge in their development.