

Supervision on Offshore Financial Centers

Harutoshi Oda

Contents

	page
1. Introduction	130
2. OFCs	131
3. Vulnerability of OFCs	133
4. International Policy Initiatives	135
(1) Financial Stability Forum (FSF)	
(2) Basel Committee on Banking Supervision (BCBS)	
(3) Financial Action Task Force (FATF)	
5. IMF Assessment	139
6. Conclusion	143
7. References	143

1. Introduction

This paper takes a closer look at the Offshore Financial Centers (OFCs) which have been changing in its traditional character from confidentiality, tax advantage and lax regulation to loyalty in observing international financial standards. As well known, OFCs have developed as a loophole of financial structure in industrialized countries. As far as its presence has been negligible, rich countries have overlooked OFCs' financial activities. However such times have gone and new stage of introduction of regulations and responsibility on supervision has just been opened. It is true that there are problematic business in some OFCs, and they have come to raise vulnerability for international financial stability. In order to tame the vulnerability, international standard setters try to cooperate with OFCs in various financial fields. Subsequently many OFCs have published assessments by/with IMF, which means that they admit to observe international standards including setting up legislative measures in their

jurisdiction and being under surveillance of IMF. In this paper, I will research how such regulations on OFCs are to bring into being introduced now.

The Paper is structured as follows. Section 2 provides characters of OFCs and definition about OFCs. Section 3 gives the characters of OFCs inevitably having been related to vulnerability for global financial stability. In order to reduce risks which stem from financial operations in OFCs, formulation of plans by international policy initiatives is given in section 4. A report on which IMF assessed present situation of OFCs is explained in section 5. The conclusions and suggestions for further research are presented in section 6.

2. OFCs

It seems normal procedure to start from considering definition of key word OFCs, however, I will choose more practical way to clarify what are the offshore business and their purposes there.

While business conducted in OFCs covers a wide range of financial sectors, such as banking, insurance, securities, and some nonfinancial activities¹, banking is the most prevalent business. Most banks located in OFCs are branches or subsidiaries of international banks to collect deposits and channel them back to their parent institutions. Private banking for clients includes asset management, estate planning, foreign exchange trading, and pension arrangements. Financial firms use special purpose vehicles (SPVs) for securitisation, and nonfinancial corporations use them to lower the cost of raising capital. Insurance business-including life, reinsurance, and captive-is also conducted in some OFCs. Asset protection, including trusts, is another service offered by OFCs. Reasons for managing assets in OFCs include protection from weak domestic banks or currencies, additional legal protection from lawsuits in the home jurisdictions, and tax avoidance. The activities described above are often undertaken through international business companies (IBCs).

In business of OFCs, there are legitimate purposes and illegal ones. OFCs can be used for legitimate reasons². However they can also be used for dubious purposes, such

1 IMF(3), p32 and Financial Stability Forum, p11.

Supervision on Offshore Financial Centers

as tax evasion and money-laundering, by taking advantage of a higher potential for less transparent operating environments, including a higher level of anonymity, to escape the notice of the law enforcement agencies in the “home” country of the beneficial owner of the funds.

Having a certain concrete image of business in OFCs , now we have come to a position to discuss definition of OFCs. However, almost every researcher on OFCs admits that it is difficult to define OFCs. For example, IMF describes as follows³:

Amongst the many definitions of OFCs, perhaps the most practical characterizes OFCs as centers where the bulk of financial sector transactions on both sides of the balance sheet are with individuals or companies that are not residents of OFCs, where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents. Thus many OFCs have the following characteristics:

- *Jurisdictions that have financial institutions engaged primarily in business with non-residents;*
- *Financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies; and*
- *More popularly, centers which provide some or all of the following opportunities: low or zero taxation; moderate or light financial regulation; banking secrecy and anonymity.*

Salim M. Darbar et al. describes as follows⁴:

One definition of an OFCs is a jurisdiction whose financial sector account for a significant share of its domestic economy. Another is that a majority of financial transactions conducted by institutions located in that jurisdiction are conducted on behalf clients who reside in other jurisdictions.

2 Financial Stability Forum, p20.

3 IMF (1), p2.

4 IMF (3), p32.

Financial Stability Forum's (FSF) Working Group of Offshore Centres defines them as⁵:

Any jurisdiction can be considered "offshore" to the extent that it is perceived as having a more favourable economic regime than another, e.g., low corporate tax rates, light regulation, special facilities for company incorporation, or highly protective laws.

Thus the common elements of the definition in above three are:

- (1) In IMF and Salim M. Darbar et al., OFC is a jurisdiction which provides financial services to nonresidents.
- (2) In FSF and IMF, OFC has favourable regime of low tax rates, light regulation, and confidentiality.

In this paper, OFC is defined as having criteria above (1) and (2).

What actual geographic jurisdictions are equivalent to OFCs described above? IMF classifies OFCs into three categories⁶: International Financial Centers-such as London, New York, and Tokyo-with large international full-service; Regional Financial Centers-such as Hong Kong, Singapore, and Luxembourg-with developed financial markets in relatively small domestic economies; OFCs-such as Cayman Islands, Cook Islands-with mainly much smaller, more limited specialist services, more lightly regulation, lax supervision. However OFCs are defined in this third category, to some extent former two financial centers fit as well when we adopt the above mentioned definition. See Table 4 in pages 141-2 that lists up significant OFCs according to IMF.

3. Vulnerability of OFCs

The characters of OFC described above directly and apparently lead to serious vulnerability for international financial stability. To clarify some recent examples of international bank failures is to understand how OFCs relate to those incidents.

5 Financial Stability Forum, p9.

6 IMF (1), p8

Supervision on Offshore Financial Centers

Bank of Credit and Commerce International (BCCI), which had a complex structure using several OFCs, failed in June 1991⁷. It is clear that the purpose to establish complex corporate structure in OFCs is to impede effective consolidated supervision. Offshore banking operations have played a role in the recent financial crises of Asia⁸, where regulatory and fiscal advantages induced many Asian banks to tap international capital markets through offshore establishments. Economic turmoil had appeared situation that Asian banks could not pay their unbridled borrowing of foreign currency, which led to Asia into crisis. Another noteworthy case was the failures of the hedge fund Long-Term Capital Management (LTCM) in 1998 which would have been complicated by its offshore status in workout process.

The failures of financial companies described above stem from vulnerability of OFCs which is classified into two types: Prudential concerns and market integrity⁹. Inherent characters of OFCs such as weak supervision, lack of co-operation and poor transparency can impair the detection of excessive risk exposures and inadequate risk-management systems. Market integrity concerns arise chiefly from the favourable secrecy, trust and asset protection regimes. These features potentially allow such OFCs to attract money of criminal origin, tax fraud, tax evasion, and other illicit financial activities, and thwart the application of international financial and economic sanctions. Asian crisis and LTCM failure are applicable to the former prudential concerns and BCCI fits the latter market integrity case.

The substance of the problems lies not only in both prudential and market integrity concerns, but also in both regulation and supervision in OFCs. In regulation, OFCs create inadequate due diligence in incorporation and licensing of new financial institutions and shell companies (IBCs and SPVs): inadequate disclosure rules: inadequate knowledge of activities of financial institutions based in OFCs. In supervision, there are obstacles to reform: lack of resources to conduct effective supervision: absence of political will to improve the quality of supervision: lack of co-operation with onshore supervisors: excessive secrecy laws.

7 Financial Stability Forum, p17.

8 IMF (2), pp.6-10.

9 Financial Stability Forum (2000), p20.

4. International Policy Initiatives

There are many ongoing initiatives aimed at curbing OFCs' vulnerability in lax financial supervision, tax evasion, and financial crime. While Basel Committee's Banking Supervision (BCBS) has tackled for years on effective supervision, OECD and Financial Action Task Force (FATF) have more recently become major regulators for tax evasion and financial crime. FSF considered that OFCs should adopt and implement the international standards and subsequently standards setters assess their compliance with standards. FSF also claimed that IMF is a proper assessor because provision of IMF gives IMF surveillance right.

(1) Financial Stability Forum (FSF)

The Financial Stability Forum's Working Group on Offshore Financial Centers (WGOC) was set up to review the uses and activities of OFCs and their significance for global financial stability. In 2000, WGOC pointed out problems with OFCs, which arise principally from inadequate supervision in OFCs and can hinder supervision in onshore centres, posing a potential threat to the global financial system.

Table1. Grouping of OFCs by Financial Stability Forum

Group	OFCs
Group1	Hong Kong SAR, Luxembourg, Singapore, Switzerland, Dublin, Guernsey, Isle of Man, Jersey
Group2	Andorra, Bahrain, Bermuda, Gibraltar, Labuan, Macau SAR, Malta, Monaco
Group3	Anguilla, Antigua, Aruba, Belize, British Virgin Islands, Cayman Islands, Cook Islands, Costa Rica, Cyprus, Lebanon, Liechtenstein, Marshall Islands, Mauritius, Nauru, Netherlands Antilles, Niue, Panama, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Samoa, Seychelles, The Bahamas, Turks and Caicos, Vanuatu

Source: Offshore Financial Centres-IMF Back Ground Paper (2000).

Supervision on Offshore Financial Centers

WGOC grouped OFCs into three categories according to the quality of supervision and the degree of co-operation by a jurisdiction¹⁰:

The first group (Group I) jurisdictions are viewed as co-operative, with a high quality of supervision (table.1). The second group (Group II) jurisdictions are seen as having procedures for supervision and co-operation in place, but where actual performance falls below international standards, and there is substantial room for improvement. The third group (Group III) jurisdictions are seen as having a low quality of supervision, and/or being non-co-operative with onshore supervisors, and with little or no attempt being made to adhere to international standards. The Group recommends that priority for assessment be placed on those Group II OFCs. Priority could also be given to those jurisdictions with the most significant financial activity.

The WGOC's report gives a solid foundation for path to IMF assessment.

(2) Basel Committee on Banking Supervision (BCBS)

Offshore banking has been at the core of the Basel Committee's work since the mid-1970s. The end of 1974 following the collapse of Bankhaus Herstatt in West Germany made the opportunity to form the Basel Committee on Banking Supervision (BCBS) which is made up of representatives of the central bank from the G10 plus Switzerland, Luxembourg and Spain, and the first meeting took place in 1975. Initially it discussed international co-operation in order to close supervisory gaps.

In 1975 the Committee agreed the Basel Concordat, which laid down a division of responsibilities among national authorities to try to ensure that there were no gaps in the supervisory net caused by the foreign operations of banks¹¹. It established that the home country supervisor of the parent bank was responsible for the prudential supervision of branches of foreign banks but the local or host supervisor was responsible for subsidiaries.

10 Financial Stability Forum, pp.12-13.

11 It is often said that the agreements on which the Committee reaches have no legal ground force, however, they have the implicit compulsory power to abide by.

Supervision on Offshore Financial Centers

The supervision responsibility based on difference of types in the foreign establishments moved back and new agreement in 1983 stressed home country supervisors' responsibility:

BCBS of 1975 was amended to ensure that where host supervision of subsidiaries was not adequate, the home supervisor should extend their supervision or discourage the bank from retaining the subsidiary.

In 1992, following the closure of the Bank of Credit and Commerce International (BCCI), the Committee agreed minimum standards for the supervision of international banking groups and their cross-border establishments. This required that a host country would determine whether the bank's home country supervisor had the necessary capabilities to meet minimum standards laid down by the Committee. The home authority should monitor banks' global operations on the basis of verifiable consolidated data, be able to prohibit corporate structures which impede supervision and be able to prevent banks from establishing a presence in suspect jurisdictions.

The Committee laid down that¹²: (1) All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision. (2) The creation of a cross border banking establishment should receive the prior consent of both the host country supervisory authority and the bank's and, if different, the banking group's home country supervisory authority. (3) Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home country supervisor. (4) If a host country authority determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments.

The working group consisting of members of the Basle Committee on Banking Supervision and the Offshore Group of Banking Supervisors was established in order to consider a number of problems which had been experienced in the implementation

¹² BIS (2), pp.1~6.

Supervision on Offshore Financial Centers

of the Basle Committee's report Minimum Standards¹³. In June 1996, the report was discussed at the Ninth International Conference of Banking Supervisors in Stockholm attended by supervisors from one hundred and forty countries.

In order to improve the access of home supervisors to information necessary for effective consolidated supervision, host jurisdiction authority should disclose customers' names or have legislation amended¹⁴. Also the working group has formulated a set of principles of effective consolidated supervision which could be used by host supervisors as a checklist to assist in determining whether a home supervisor is meeting the Minimum Standards.

(3) Financial Action Task Force (FATF)

The FATF is created to adopt and implement measures designed to counter the use of the financial system by criminals. It set out the basic framework for anti-money

Table2. Historical List of NCCTs

	NCCT list
June 2000	Bahamas, Cayman Islands, Cook Islands, Dominica, Israel, Lebanon, Liechtenstein, Marshall Islands, Nauru, Niue, Panama, Philippines, Russia, St. Kitts and Nevis, and St. Vincent and the Grenadines
June 2001	Cook Islands, Dominica, Egypt, Grenadines, Guatemala, Hungary, Indonesia, Israel, Lebanon, Marshall Islands, Myanmar, Nauru, Nigeria, Niue, Philippines, Russia, St. Kitts and Nevis, St. Vincent, Grenada, Ukraine
June 2002	Cook Islands, Grenadines, Guatemala, Egypt, Indonesia, Myanmar, Nauru, Nigeria, Philippines, St. Vincent, Ukraine
June 2003	Cook Islands, Egypt, Guatemala, Indonesia, Myanmar, Nauru, Nigeria, Philippines, Ukraine
July 2004	Cook Islands, Nauru, Philippines, Indonesia, Myanmar, Nigeria

Source: FATF (2004) http://www1.oecd.org/fatf/NCCT_en.htm.

13 BIS (4).

14 BIS (3), pp.3~7.

laundering (AML) principles The Forty Recommendations which is now the principal standard. Following the terrorist attacks in the United States on 11 September 2001, the FATF expanded its mission to combat terrorist financing (CFT)¹⁵.

To reduce the risks of the international financial system to misuse by criminals, the FATF is also involved in examining and identifying the serious and systemic weaknesses in the anti-money laundering programmes of certain jurisdictions. FATF have named non-cooperative countries and territories (NCCTs) as having critical deficiencies in their anti-money laundering systems (table 2).

5. IMF Assessment

The Fund, in collaboration with other international organizations and relevant standard-setting bodies, has stepped up efforts aimed at strengthening member countries' capabilities for the implementation of effective consolidated supervision, including through the Financial Sector Assessment Program (FSAP), Basel Core Principles Assessments, as well as technical assistance activities. National supervisory

Table 3. Summary Status of Contacted Jurisdictions

	Total
Published or to be published ^{1/}	26
Ongoing or under review ^{2/}	13
Unpublished ^{3/}	2
Planned in CY 2004-05	1
Total jurisdictions assessed	42
TA scheduled in lieu of assessments in CY 2004	2
Total jurisdictions contacted	44

^{1/} 21 reports have been published, 4 jurisdictions have confirmed their intention to publish, and one is expected to publish.

^{2/} 11 reports are under review and 2 assessments are on going.

^{3/} 2 jurisdictions declined to publish.

Source: IMF (2004), Offshore Financial Centers, The Assessment Program-An Update.

15 FATF, http://www1.oecd.org/fatf/NCCT_en.htm.

Supervision on Offshore Financial Centers

authorities, on their part, have been implementing a number of practical safeguards and countermeasures, partly as a result of the negative experiences described previously, to deal with risks surrounding the use of OFCs.

IMF initiated the OFCs assessment program in 2000 and reviewed in 2003. Table 3 shows that 41 of the 44 contacted jurisdictions at the start of the program have been assessed or are in the process of being assessed either through a Module 2 assessment or under the FSAP¹⁶. There are two types of IMF assessment program of Module 2 and FSAP. The differences between the two are that while a Module 2 assessment involves assessing the compliance of supervisory and regulatory systems with international standards and it also evaluates the effectiveness of the anti-money laundering and combating the financing of terrorism regime, assessment under the FSAP, in addition to assessments of observance of relevant financial sector standards and codes, includes an assessment of risks to macroeconomic stability. While publication of assessments is voluntary, a large majority have opted to publish their reports to show their will to improve supervision.

Through assessment important key findings are emerged (table 4)¹⁷:

- (1) The higher financial standard compliance OFCs reflects the higher income levels of the OFCs. They have to protect their reputation because the financial sector contribution to the economies is large.
- (2) Vice versa in (1). OFCs with lower per capita income have inadequate resources and expertise in the supervisory agencies.
- (3) In banking, about 40 percent of the jurisdictions need to strengthen in two areas: supervisors' independence and resources, and onsite and offsite examinations.
- (4) In insurance, onsite inspection was a key deficiency-with only about 50 percent jurisdictions being rated observant or highly observant with the standard.
- (5) In securities, about 60 percent of jurisdictions need to improve implementation of the standard in two areas: increasing powers provided to the supervisor, including more resources and developing plans to deal with the failure of firms selling.
- (6) In AML/CFT, about 40 percent of jurisdictions had deficiencies in AML rules and procedures, and 35 percent did not pay sufficient attention to transactions with higher

16 IMF (2004), p5.

17 IMF (2004), pp.6-8.

Supervision on Offshore Financial Centers

Table4. IMF Assessment

	BCP	ICP	SCP	FATF	Compliance(FSF)
Seychelles	✓			✓	(3)
Cook Islands	✓			✓	(3)
Macao SAR	✓	✓			B (2)
Malaysia	✓	✓	✓	✓	(2)
Marshall Islands	✓			✓	(3)
Nauru					(3)
Niue					(3)
Palau	✓			✓	
Samoa	✓			✓	(3)
Vanuatu	✓	✓		✓	C
Andorra	✓			✓	A (2)
Cyprus	✓				B (3)
Gibraltar	✓	✓	✓		A (2)
Guernsey	✓	✓	✓	✓	A (1)
Isle of Man	✓	✓	✓	✓	A (1)
Jersey	✓	✓	✓	✓	B (1)
Liechtenstein	✓	✓	✓	✓	B (3)
Monaco	✓		✓	✓	B (2)
Anguilla	✓			✓	B (3)
Aruba	✓	✓			B (3)
Bahamas	✓		✓	✓	(3)
Belize	✓	✓		✓	(3)
Bermuda	✓	✓	✓	✓	(2)
Virgin Islands	✓	✓		✓	(3)
Cayman Islands	✓	✓	✓	✓	(3)
Montserrat	✓			✓	B
Antilles	✓	✓		✓	(3)
Panama	✓				B (3)
Turks Caicos	✓			✓	(3)
Mauritius	✓			✓	B (3)

Supervision on Offshore Financial Centers

Hong Kong SAR	✓	✓	✓	✓	A (1)
Singapore	✓	✓	✓	✓	(1)
Bahrain					n.a. (2)
Luxembourg	✓	✓	✓	✓	A (1)
Malta	✓	✓	✓	✓	A (2)
Switzerland	✓	✓	✓	✓	A (1)
Antigua	✓			✓	(3)
Barbados	✓	✓	✓	✓	A
Costa Rica	✓				B (3)
Dominica	✓			✓	
Grenada	✓			✓	
St. Kitts Nevis	✓			✓	(3)
St. Lucia	✓			✓	(3)
St. Vincent and Grenadines	✓			✓	(3)

Notes:

BCP=Basel Core Principles

ICP=IAIS Core Principles

SCP=ISOCO Objectives and Principles

FATF=FATF Forty Recommendations against Money Laundering and Eight Special Recommendations on Terrorist Financing.

OFCs are assessed in checking standards.

Compliance A means high, B shows room for improvement and C means low, blank means ongoing. Its evaluation is by author.

Source: IMF, Offshore Financial Centers, The Assessment Program-An Update (March 2004).

risk countries and needed to strengthen measures to ensure. In compliance with the standards for CFT, 50 percent of the jurisdictions need to strengthen measures to impose AML requirements on alternative remittance systems.

6. Conclusion

OFCs usually located in small islands and provide financial facilities of banking, insurance, SPVs and IBCs controlled by non residents. Users from industrialized countries extend their business to OFCs for various reasons: lower tax, light regulation and confidentiality. Authorities of some OFCs have had no interest with regulation and supervision so far, and lack of both information and co-operation has made it difficult for home supervisors to perform efficient supervision.

Thus business in OFCs has problems in prudential and market integrity concern originally, which standard setters have tried to solve. The process to tame vulnerability of OFCs initiated by FSF has started through assessment approach with IMF. To publish their assessments means to declare that OFCs will keep the compliance of international standards. However, in order to make the process effective, IMF should provide resources to lower income OFCs which have inadequate resources and expertise in the supervisory agencies. It means that after all international societies should consider how to co-operate with problematic OFC jurisdictions.

Remaining questions are: after the process will be completed and supervision will start to work well, what kind of business will remain in OFCs? It is easy to suppose that some offshore businesses such as related confidentiality and criminal will shift back to onshore. However it is difficult to expect how large the shift and its impact on the financial markets will be.

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