

# In defence of international financial centres

Global leaders are expected to continue with the pressure they have created for international financial centres to disclose more tax-related information at this month's G-20 summit in Pittsburgh. **Jennifer Thomson and Philip Paschalides** rise to the defence of these international centres and their business models.

The axiom has often been repeated that a good scapegoat is nearly as welcome as a solution to the problem. Indeed, the truth of this statement has been keenly felt in international financial centres (IFCs) such as the Cayman Islands, the British Virgin Islands and Jersey, which have experienced an unprecedented level of media attention over the past 12 months. As world leaders faced the heat on the woeful state of the global economy (and found it difficult to explain the involvement of regulators and central banks in the debacle), attention quickly turned to IFCs, which felt they were being employed as convenient decoys by those seeking to escape the critical attention. The hype reached a climax around the time of the G-20 summit in April.

The governments of – and the financial services professionals working in – the most successful and mature IFCs have despaired at the lack of understanding of their business models and the benefits that they offer to the G-20 and other onshore jurisdictions. Their relative size and absence of representation at the decision-makers' tables has made it difficult for IFCs to get their message across.

While the reality is much less interesting and glamorous than the outdated stereotype peddled by the entertainment industry and the media, it is important that it be understood by policymakers onshore and by the custodians of our global economy.

Even the most mature IFCs are often criticised for offering some or all of the following services: moderate or light financial regulation, banking secrecy and anonymity and low or zero taxation.

## Regulation

Although one of the most frequently cited characteristics of IFCs are their light financial regulation, it is noteworthy that none of the banks in the Cayman Islands (the world's fifth banking centre)

failed during the recent crisis. Indeed, the Cayman Islands Monetary Authority, the Jersey Financial Services Commission and the British Virgin Islands Financial Services Commission (which regulate hedge funds, banks and insurance companies) are full members of the International Organisation Securities Commission, are members or observers of the Offshore Group of Banking Supervisors and adopt the Basel core principles for banking.

The Cayman Islands, the British Virgin Islands and Jersey are already subject to and have had a number of successful compliance reviews by the FATF and the IMF over the past decade with respect to their anti-money-laundering and financial regulation. Obviously, this endorsement from such international bodies suggests that the level of regulation is entirely appropriate and proportionate, given the activities and business models of these jurisdictions.

## Banking secrecy

It is undeniable that the financial services industry in certain jurisdictions has flourished owing to very strict banking secrecy legislation. Businesses in those countries have attracted a high net worth client base looking to invest in a location that guarantees them privacy in their financial affairs. It is often assumed that the sole reason for establishing an offshore bank account is tax evasion, but there are entirely legitimate reasons for doing so that are unrelated to tax evasion, such as seeking the benefit of political stability, client service, reputation and financial security.

An individual living in a country with a repressive political regime may well, for example, select such a jurisdiction as a safe harbour for his or her financial affairs. However, to the extent that tax evasion is a motivating factor, any guarantee of secrecy in the mainstream financial centres is a thing of the past – all the indications are that the ability of the tax authorities in

other jurisdictions to access information previously denied them is increasing at great speed, and the well-publicised battles between UBS and the US government are a clear indicator of the changing times. Will this have an impact on this area of their business? Of course it will. But a number of these jurisdictions already have diversified financial services industries that will continue to attract different types of business, and a number of them left behind this sort of business model some time ago.

Some IFCs may historically have attracted business on the back of their confidentiality legislation, but that feature has played a less and less significant role over the years. Such IFCs are unlikely to be affected by any push to change their banking secrecy legislation. A number of them (such as the Cayman Islands) have already undertaken an assessment of confidentiality provisions on their statute books with a view to removing a few stray provisions that have long been considered redundant in practice. The international focus on tax information exchange and transparency has, in some cases, simply acted as the catalyst for the IFCs to engage in practices to which they were already committed in principle and to spring clean their legislative cupboards in order to ensure that their regimes reflect the reality of the business being conducted there. Financial centres are focusing on what type of business it is that they do and the type of business they want to do.

## The IFC business model

The more mature IFCs (for whom the end of secrecy is not an issue) are generally sophisticated business communities boasting a developed infrastructure that can attract and accommodate a high standard of professional service providers. It would simply not be possible for an IFC like the Cayman Islands to become and function as the fifth largest banking centre

by volume of deposits were it not so. Such IFCs have evolved from the secrecy model, where assets may be immobilised inside a jurisdiction, to provide a much more dynamic service, acting instead as conduits through which the currents of international capital may flow efficiently. For them, the age of banking secrecy has been over for many years.

Such mature, institutionally-oriented IFCs are home to companies, trusts and partnerships (each an IFC vehicle) that act as investment funds, issuers in capital markets and structured finance transactions, providers of insurance and alternative risk transfer arrangements, as well as financing or ownership vehicles for commercial aircraft and ships or for infrastructure projects taking place in virtually every part of the globe. The clients who arrange, sponsor and participate in these structures are high profile fund managers, leading banks, governments and supranational organisations, and they are all utilising mature IFCs on account of the various features offered by them, which enable and optimise certain commercial activities.

Mature IFCs have a number of features. They are generally common law jurisdictions that have enacted specialist legislation to facilitate certain types of investment structure or financing transactions. Mature IFCs also have creditor-friendly legal systems, which make them a good venue for finance transactions because creditors are given a strong legal position against their debtors.

Another feature of IFCs is that they offer legal neutrality, such that investors from one nation can do business with investors from another on neutral ground and on equal footing with one another, enabling international capital to be pooled freely. Mature IFCs are generally politically, socially and economically stable, both making them ideal service jurisdictions and also giving them stronger sovereign credit ratings from the rating agencies. This consequently makes lending to IFC vehicles less risky and enables more efficient financing.

Mature IFCs attract a highly professional workforce and offer strong local representation from quality service providers such as lawyers, accountants, administrators and banks. In addition,

mature IFCs generally have no exchange controls or other factors that impede the free movement of capital or constitute a cost to or charge on investment structures.

### The truth about tax

One factor is noticeably absent from the above list, perhaps because it is not really a factor in its own right in many cases: tax neutrality. The choice of term is intentional. It means that the decision to use an IFC vehicle is neutral for tax purposes. The term does not mean that an IFC is used to avoid a tax. IFC vehicles will never escape paying taxes that are due in the jurisdiction where they operate or have assets, and investors who hold the equity or debt of IFC vehicles will always themselves be liable to pay any taxes due in their home jurisdiction. Tax neutrality merely means that investors or finance parties take advantage of the many legal and other structural benefits offered by an IFC without any dilution of their returns, since no levy is made by the IFC on either capital or income as it flows through the IFC.

The business model of the mature IFCs is therefore geared up to facilitate the collection of capital at a single neutral point and to enable cost-effective movement of that capital to the places in the global economy where it can make a difference or earn a handsome return.

For mature IFCs following that business model (such as the Cayman Islands, the British Virgin Islands or Jersey), the tax haven label so unthinkingly applied to them by the media constitutes a gross misunderstanding of what business these jurisdictions engage in and how vital it is to the workings of the global economy.

### Exchange of information

Of course, the media spotlight has centred on tax evasion as the primary mischief to be eliminated in our time of crisis. The fact that banking secrecy (and its alleged support of unwholesome activities) is not a major consideration of most IFC business models is evidenced by the developments in tax information exchange over the last 12 months.

Although the initiatives of the OECD in countering "harmful tax competition" had been ongoing since 1998, they received

fresh support as a direct result of the global financial crisis. In the months before and after the April 2009 G-20 summit, at which the consideration of tax havens was on the agenda, there has been a clear rush by many IFCs to sign up tax information exchange agreements in order to meet the internationally agreed tax standard.

A number of the most reputable IFCs were either judged at the outset as having substantially implemented the standard and thus appeared on the OECD's so-called white list or have since then been added to that list. Other countries are expected to follow suit.

The OECD has indicated that over the coming months, its committee on fiscal affairs and the global forum will review its standards to take account of more qualitative issues. It is not anticipated that the serious jurisdictions operating as IFCs will do anything but welcome and respond to the outcome of those reviews. Many are active or contributors to OECD committees addressing tax harmonisation issues and will welcome opportunities for further cooperation and seek to consolidate their position as valuable contributors to the global economy.

### Revising the political agenda

IFCs expect to find themselves on the agenda at the next G-20 summit in Pittsburgh and therefore, once again, inspire column inches and headlines and are the subject of discussion by world leaders. Hopefully, recent events will have convinced the G-20 of the cooperative intentions of the IFCs and, by September, those leaders will have understood that this cooperation runs deeper than merely signing up to the requisite number of exchange agreements. During the same period that IFCs were the object of constant misunderstanding and misrepresentation, they were ironically participating in the measures designed to promote stability in the global economy. One wonders how many IFC vehicles are now supporting the US government TALF programme.

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