Offshore Financial Services Guide 2005-06

Snapshot and description of 30 major offshore centres
Directory of offshore service providers
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- Terrorism clean-up offers opportunities for offshore centres
- Hutchison Whampoa’s CFO on the importance of being blue chip
- Top tax lawyer talks treaty-shopping
- Why Hong Kong doesn’t like to be considered offshore
- New recipe needed for alphabet soup of regulators
Alex in Hong Kong: Only in The Standard
Offshore Financial Services Guide 2005-06

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Terrorism clean-up opens opportunity for offshore centres

There have been many other elusive reclusive multi-millionaires in the world before, but it is hard to think of one with the devastating impact that Osama bin Laden wrought from his Afghan fastness on September 11, 2001. For the administration of US President George W Bush and for Western civilisation as a whole it is a challenge that has not yet been won. But the ripples spread far and wide beyond New York and Washington, the immediate targets of the attack, and far beyond the Middle East or Iraq, where Bush feared that Saddam Hussein was getting ready to launch weapons of mass destruction, or Afghanistan. Suicide bombings in London in 2005 by British Muslims underline the direct threat to the big global financial centres, and showed that it is one that may come from inside as well as from outside their own societies. But the shockwaves also reached the furthest and most remote of the tropical island offshore financial centres. For small places like Vanuatu or the Bahamas the chances are remote to nil that al-Qaeda or its friends or imitators would be bothered to launch a direct attack on them. Instead they soon felt the big guns, so to speak, of the rich western world being directed towards them.

After the immediate impact of devastation, destruction and death in the shadow of Wall Street, the financial focus turned to stemming the flow of funds that feed the terror machine. The terrorists actually spent relatively little on perpetrating their bombings of the World Trade Center and the Pentagon. Some experts calculated that the perpetrators spent merely US$18,000, not including telephone bills of US$6,000 that the dead men left behind unpaid. (The US State Department puts a higher figure of half a million dollars that the terrorists had to spend to wreak the New York and Washington atrocities). But of course that cost is only the tip of an iceberg of support money that maintains the al-Qaeda and other terrorist pipelines.

What the atrocity did was remind everyone of the vulnerability of the global financial system. Offshore financial centres in particular, which were already under close scrutiny for allegedly being launderettes for dirty money, began to feel even more vulnerable as an alphabet soup of investigatory authorities closed in on them. The IMF, the OECD, the G7, the FATF, FSE, IOSCO, BCBS, IAIS began to press their demands more insistently that the offshore centres clean up their acts. (For some of the ingredients of alphabet soup, see box page 13)

Some of the onshore big countries even began to see an opportunity to put the small offshore island centres out of business. After decades of growth, which had seen a Who’s Who of international business set up offshore operations and be joined there by a glitterati of superstars from Michael Jackson to Michael Jordan and Michael Schumacher, was this the beginning of the end for the paradise islands? One European newspaper declared “After dirty air, dirty money,” promising that clean-up was the new global political prerogative. Then came Osama bin Laden’s terrorists, provoking questions as to whether the offshore financial centres could survive the crackdown. But on the contrary now, a few years on, some of the offshore centres are realising that the clean-up may prove profitable for them after all in demonstrating that they have a role to play in a rapidly globalising world. (See box on next page for IMF guide to uses and abuses of offshore centres.)
Offshore banking licences

There are many possible ways in which offshore banking licences may be useful to a variety of corporate or financial players: for example, a multinational company may set up an offshore bank to handle its foreign exchange operations or to facilitate financing of an international joint venture; or an onshore bank may establish a wholly owned subsidiary in an offshore financial centre (OFC) to provide offshore fund administration services, such as full integrated global custody, fund accounting, fund administration and transfer agent services; or the owner of a regulated onshore bank may find it useful to have a sister “parallel” bank in an OFC. The attractions of the OFC may include most or all of the following: no capital tax, no exchange controls, light regulation and supervision, less stringent reporting requirements and less stringent trading restrictions.

Offshore companies or international business corporations (IBCs)

IBCs are limited liability vehicles registered in an OFC. They may be used to own and operate businesses, issue shares, bonds or raise capital in other ways. They can be used to create complex financial structures. IBCs in most OFCs are flexible and can often be set up with only one director. In some cases, residents of the OFC host country may act as nominee directors to conceal the identity of the true company directors. In some OFCs, bearer share certificates may be used. In other OFCs, registered share certificates are used, but no public registry of shareholders is maintained. In many OFCs, the costs of setting up IBCs are minimal and they are generally exempt from all taxes. IBCs are a popular vehicle for managing investment funds.

Insurance companies

A commercial corporation establishes a captive insurance company in an OFC to manage risk and minimise taxes. An onshore insurance company establishes a subsidiary in an OFC to reinsure certain risks underwritten by the parent and reduces overall reserve and capital requirements. An onshore reinsurance company incorporates a subsidiary in an OFC to reinsure catastrophic risks. The potential attractions of an OFC in these circumstances include favourable income prospects or the lack of withholding taxes or capital taxes or low or weakly enforced actuarial reserve requirements and capital standards.

Special purpose vehicles (SPVs)

One of the most rapidly growing uses of OFCs is the use of special purpose vehicles to engage in financial activities in a more favourable tax environment. An onshore corporation establishes an IBC in an offshore centre to engage in a specific activity. The issuance of asset-backed securities is the most frequently cited activity of SPVs. The onshore corporation may assign a set of assets to the offshore SPV, for example, a portfolio of mortgages, loans and credit card receivables. The SPV then offers a variety of securities to investors based on the underlying assets. The SPV, and hence the onshore parent, benefit from the favorable tax treatment in the OFC. Financial institutions also make use of SPVs to take advantage of less restrictive regulations on their activities. Banks, in particular, use them to raise Tier I capital in the lower tax environments of OFCs. SPVs are also set up by non-bank financial institutions to take advantage of more liberal netting rules than faced in home countries, reducing their capital requirements.

Tax planning

Wealthy individuals make use of favourable tax environments in, and tax treaties with, OFCs, often involving offshore companies, trusts, and foundations. There is also a range of schemes that, while legally defensible, rely on complexity and ambiguity, often involving types of trusts not available in the client’s country of residence. Multinational companies route activities through low-tax OFCs to minimise their total tax bill through transfer pricing, that is, goods may be made onshore but invoices are issued offshore by an IBC owned by the multinational, moving onshore profits to low-tax regimes.

Tax evasion and money laundering

There are also individuals and enterprises that rely on banking secrecy to avoid declaring assets
and income to the relevant tax authorities. Those moving money gained from illegal transactions also seek maximum secrecy from tax and criminal investigation.

Asset management and protection

Wealthy individuals and enterprises in countries with weak economies and fragile banking systems may want to keep assets overseas to protect them against the collapse of their domestic currencies and domestic banks and outside the reach of existing or potential exchange controls. If these individuals also seek confidentiality, then an account in an OFC is often the vehicle of choice. In some cases, fear of wholesale seizures of legitimately acquired assets is also a motive for going offshore. In this case, confidentiality is very important. Also, many individuals facing unlimited liability in their home jurisdictions seek to restructure ownership of their assets through offshore trusts to protect those assets from onshore lawsuits. Some offshore jurisdictions have legislation in place that protects those who transfer property to a personal trust from forced inheritance provisions in their home countries.


There was certainly no doubt about the strength of feeling against the offshore financial centres. Concerns expressed by big international bodies were only the very distinguished solo parts among a whole wailing opera chorus blaming the offshore centres for all sorts of offences from stashing away as much as several trillion dollars a year, aiding and abetting terrorism, helping the Russian Mafia run off with large chunks of billion dollar international loans, being part and parcel of the Enron crookery, being a British plot to perpetuate an ignoble empire, helping to undermine the world’s financial system and stealing the tax dollars of the poor and depriving the world’s poorest people of US$50 billion a year.

One example of the extreme claims made by economists who would be considered moderate came from the journalist Will Hutton, former editor of The Observer, one of the oldest newspapers in the world, and academic Anthony Giddens, then the director of the London School of Economics and mentor of British prime minister Tony Blair even before Downing Street wonkathons started. The two wrote of the offshore centres in their book On the Edge published in 2000: “They distort the global economy, allow the rich to avoid taxation and also help authoritarian regimes. So many dire political leaders and oligarchies have bled their countries dry by siphoning off funds abroad. Tax havens, countries with anonymous bank accounts and so forth are deeply implicated in this.”

Prem Sikka, professor of accounting at the University of Essex, declared that the offshore centres were part of the dark side of capitalism: “Capitalism is inherently crisis-ridden, but shows little sign of exhausting itself. It continues to develop new ways of reinvigorating itself and generating economic returns for capital. Globalisation is considered to be the most advanced phase of capitalism. The offshore financial centres are an integral part of capitalism. They facilitate growing mobility of finance by facilitating no/low tax, no/low regulation, secrecy and anonymity to enable footloose capital to roam the world. Their policies play a key role in tax avoidance/evasion, money laundering, flight of capital, degradation of regulation, instability and economic underdevelopment, and have serious consequences for people everywhere. Professional intermediaries, such as accountants and lawyers, play a key role in the development and expansion of OFCs. Despite the veneer of liberal democracy, some OFCs are captured by the finance industry and advance the interests of financial capital. Many OFCs are nurtured and protected by leading Western hegemons with developed capital and financial markets.” It is a sweeping statement that sweeps away nuances and contradictions in its quest to put the OFCs on the dark side of the world.

A book Offshore: the dark side of the global economy published in mid-2005 goes even further with author Wil Brittain Catlin, who has worked as a producer for the British Broadcasting Corporation and as an investigator for Kroll Associates, offering, according to the publisher’s blurb: “A revealing and chilling expose on the hidden side of global wealth and power... The world of offshore finance is one of dummy companies, shadow bank accounts, post office boxes, foreign registries, and the like, which allow giant corporations – such as Wal-Mart, British Petroleum and Citigroup – to keep huge profits out of sight of investors, regulators, and the public. Whether in the Cayman Islands or in the shadowy redoubts of the Islamic financial centre of Labuan, Malaysia, ‘offshore’ is where the game of profit and loss is played. A third of the world’s wealth is held offshore... He takes us into the secret networks of Enron and Parmalat, behind international trade disputes, and into organised crime and terror networks, giving disquieting
evidence that, through offshore practices, the key value of capitalism and civilisation alike – freedom – is being put in grave danger.”

The major international charity Oxfam also picked up the undoubted fact that there have been scandals and abuses involving offshore centres to claim in 2000: “Offshore tax havens represent an increasingly important obstacle to poverty reduction. They are depriving governments in developing countries of the revenues they need to sustain investment in basic services and the economic infrastructure upon which broad-based economic growth depends... At a conservative estimate, tax havens have contributed to revenue losses for developing countries of at least US$50 billion a year... We stress that the estimate is a conservative one. It is derived from the effects of tax competition and the non-payment of tax on flight capital. It does not take into account outright tax evasion, corporate practices such as transfer pricing, or the use of havens to under-report profit.”

Estimates of the vast sums that the offshore financial centres are supposed to deprive the honest law-abiding tax-paying citizens of the world vary widely. The Observer newspaper claimed that tax avoidance schemes manufactured in Monaco were costing the UK £1 billion a year. Deloitte and Touche claimed that Europe may be losing £100 billion a year and Sikka and another academic put the UK’s losses at £85 billion a year “in tax avoidance/ evasion (that amounts to a lot of hospitals, schools and pensions).” Senator Carl Levin claimed in evidence in the US Congress in July 2001 that the US losses in tax to US$70 billion of tax revenue each year.

In 2005, the London-based Tax Justice Network, a group of individuals and organizations concerned about tax losses, claimed that the sums in the offshore financial centres had reached US$11.5 trillion. In a report partly funded by the charity Christian Aid, in September 2005, it estimated that countries lose US$255 billion a year in tax revenues hidden offshore. If such a sum could be diverted back to assisting the poorest people in the world, it would solve many of the global development problems of ingrained poverty, the group claimed.

Such are some of the charges made by a variety of people, some of them of the highest repute. Even before the horror of 9/11, there was indeed concern in high global places about the dangers of crime infiltrating the financial system and potentially destroying it.

Eduardo Aninat, former finance minister of Chile, who then became deputy managing director of the IMF, warned after 9/11 in the IMF’s Finance and Development quarterly that financial crimes were like a cancer that could eat away the whole system: “Money laundering and terrorist financing are not typically linked to financial instability, but they should be. These activities are not just the by-products or precursors to often serious criminality and even acts of barbarism; they also taint otherwise unaffected people and institutions. When a financial institution is used unwittingly by criminal elements or terrorists, it risks damage to its reputation. If its staff colludes with criminal elements to launder funds or channel financing to terrorists, the damage can be much greater. Those that do business with an institution found to be engaged in money laundering may also suffer a loss of reputation, and when a financial center is widely perceived to be vulnerable to money laundering, others will shy away from investing there. The most serious dangers arise when important financial institutions are controlled by criminals, because in these circumstances the integrity and operations of the whole financial system can be compromised.

“For some countries and jurisdictions, the economic and financial impact could be significant. Once
the integrity of an institution or financial centre is brought into question, its long-term viability is at risk, with potentially serious economic consequences. Moreover, where there is a lack of integrity in financial systems, decisions on the allocation of resources are corrupted and investment is misallocated, dampening economic growth.”

An easy finger was pointed at the small offshore financial centres since it was alleged that they were not properly supervised and went out of their way to attract money at all costs, some of its of dubious provenance. So what happened on 9/11 simply added more urgency and put the world financial police – or, more correctly, some of the offshore centres grumbled – the investigators of the rich countries, at work to examine their systems, using the threat of blacklisting or labelling them as non-cooperative. Work had already begun some years before with the founding of bodies like the Financial Action Task Force, set up at their 1989 summit by the Group of Seven industrialised nations and the European Commission to combat money laundering.

The 9/11 attacks added the financing of terrorist attacks to the equation along with money laundering and tax crimes. In some ways this was a pity because the activities are different, with different roots, differing intent and in fact their perpetrators are often going in different directions.

Money laundering, as it signifies, means bringing money from the black economy, arms smuggling, drugs, forgery, fraud, prostitution, smuggling and other criminal activities, and washing it into the legitimate financial world. The actual phrase originated in the US in the 1920s because criminal gangs trying to disguise how they got their money took over businesses with high cash turnovers, such as launderettes and car washes, and mixed the dirty money with the “clean” cash receipts. The procedures today may not involve launderettes, but the principle is the same, to take dirty money and make it clean, ready to use without questions being asked about where it came from.

The sums believed to be involved are huge. The figure of US$1.5 trillion a year was given as an estimate by both the United Nations and the US in the closing years of the 20th century. Most experts said that this was just a working figure and the real numbers could be higher.

According to classical definitions provided by law enforcement agencies like the US Federal Bureau of Investigation (FBI), the process of money laundering involves three stages. The first involves placing the proceeds of the illegal activities away from the scene of the crime. For example, a government official may take a bribe in cash and put in a safe deposit box or a bank account opened in someone else’s name to conceal the ownership. Next comes layering, which involves the separation of the proceeds through the use of complex transactions that are designed to obscure the audit trail and hide the proceeds. Money is transferred from one bank account to another, from one bank to another, from one country to another or any combination of all of these to increase the difficulty of tracing the money back to its illegal source. Shell companies and offshore banks are frequently used, according to the FBI, because these put great distance between the origin of the money and its use.

The third stage of the laundering process is integration, the conversion of illegal proceeds into apparently legitimate business earnings through normal financial or commercial operations. According to FBI experts, integration, “involves techniques as numerous and creative as those used by legitimate businesses to increase profit and reduce tax liabilities. Common techniques include producing false invoices for goods purportedly sold by a firm in one country to a firm in another country, using funds held in a foreign bank as security for a domestic loan, commingling money in the bank accounts of companies earning legitimate income, and purchasing property to create the illusion of legal proceeds upon disposal.”

In fact, such a classical tripartite division of placement, layering and integration, is merely a child’s guide in today’s sophisticated financial world where, as David Blunkett, then the UK home secretary, admitted in 2002: “Organised criminals are more organised than we (the anti-crime authorities) are.”

Terror financing often involves money that might otherwise be regarded as legitimate. Typically dummy companies are set up to house assets and run bank accounts. Charities may be used, sometimes without their knowledge and consent, to collect, transfer and pay out money. Terrorist funds are mixed into businesses and shipped from country to country, using wire transfers, underground money changers and black market operators. In Europe, police have found terrorist front companies involved in publishing, real estate and fisheries. In the US, delicatessens have been discovered as collection and distribution centres for terrorist funds. The additional problem with terrorist financing is that although in total large sums of money may be involved, the individual act of terror may need only a shoestring sum. Another problem is that modern terrorists tend to bypass the traditional financial systems and to use informal exchange systems, such as hawala or hundi (or fei qian in China, sometimes called “flying chits”), which

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are difficult for law enforcement agencies to penetrate, not least because they work by moving money without actually transferring it.

Colin Powell, chairman of Jersey’s Financial Services Commission, also points to a big difference between money laundering and terrorist financing, which makes it additionally difficult to pick up on terrorists’ money: “With money laundering suspicions can be expected to be raised through evidence of large and/or unusual transactions,” he comments. “For terrorism the problem faced is that financial transactions tend to be small and they are often used for what on the face of things will appear to be normal items of expenditure, for example, paying for flying lessons.”

The 9/11 attacks thus gave new impetus to the global investigation of black money. Offshore centres found that they had to take international concerns seriously, however much they resented the high-handed way in which the OECD countries effectively forced them to undergo inspections and tests, face the threat of being blacklisted and being forced to pass remedial legislation against money laundering if they wanted to get off the black list. No one wanted to be on the black list and those that were have tried to hide the fact that they were laggards. It is hard being an international pariah.

So by late 2005, there were just three countries remaining on the Financial Action Task Force black list – Burma, which now calls itself Myanmar, Nauru and Nigeria. Nauru has effectively given up its financial activities. Nigeria is fighting hard with a former general-turned-civilian as president and a former World Bank vice president as its finance minister to throw off the baneful inheritance of Sani Abacha and his kleptocratic generals. Burma remains recalcitrant, and its ailing economy propped up by drug deals and some cosy business arrangements with neighbouring Thailand and China.

The rest of the more than 40 jurisdictions that were on one or another black list have been taken off after enacting new laws – and in cases like the Cooks Islands a whole suite of new legislation – against money laundering. Most of the so called offshore financial centres, including some that were never blacklisted, have been subjected to inspections from IMF teams, which presented lengthy reports running to 100 pages or more and offering an analysis of their strengths and weaknesses plus detailed guidelines and specific recommendations about what should be done to improve the surveillance and supervision of their financial systems.

It has to be said that a lingering bad taste remains about the way that the exercise was conducted – along with some very real issues and arguments about the roles and even the legitimacy of some offshore financial centres. The optimists say that there is a dialogue now going on and that even the OECD recognises positions that it did not before. Others caution that there need to be major changes to what is called
the international financial architecture, or there could before too long be a financial eruption that will shake the world with who knows what consequences.

Debate goes on about what role the offshore financial centres played in money laundering and financial crimes. Although it is hard to imagine a small island paradise being a centre of financial fraud – it would be like parading an elephant down Main Street, something that someone surely would notice – it has happened.

There can hardly be a less attractive Pacific paradise than Nauru, a tiny 21.2 square-kilometre island isolated in the middle of the Pacific Ocean. Its landscape is more like a moonscape with rocks with razor-sharp edges because of the excavations of the phosphate that was previously the basis of its economy. At times in the 1970s and 1980s when the world price of phosphates was high and oil prices dipped, Nauru was the richest place in the world in per capita terms, affectionately known as “Birdshit Island” because the guano droppings deposited over the centuries by seabirds. But even in the best days, it was a hellish place to be, with the world’s highest incidence of diabetes because the local population had nothing much to do except eat and drink and bet on what the frigate birds were going to do. By the late 1990s, the phosphate had been virtually mined out and spendthrift governments had run through the investments worth several billion dollars that had been kept for the proverbial rainy day. With no arable land, no supply of drinking water, no natural harbour and millions of dollars of bad debts, the virtually bankrupt Nauru set up an offshore financial centre and offered itself to all comers. According to Russian and US officials, Nauru became a major centre for tax evasion and money laundering. The US claimed that US$70 billion in Russian mafia money flowed through 400 banks registered to a single government postbox in 1998 alone (though it has to be said that it emerged later that some of the main beneficiaries were bank executives safely ensconced in New York). When the global financial police tried to intervene, the then-president accused them of trampling on Nauru’s sovereign rights. Since then, a new government has promised to mend its ways and has made some money by using the island as a processing centre for would-be refugees to Australia.

At the other extreme, a respected established offshore financial centre, the Cayman Islands, also attracted attention from both the US Congress and the British Parliament because it was the destination for not just one but 692 companies set up by Enron in pursuit of some of its scams. The Caymans also figured in the Parmalat scandal, Europe’s biggest bankruptcy, where it was discovered that four billion euros of supposed liquidity and eight billion euros in bonds had evaporated. But these critics miss the point: the Caymans can claim to be a victim and not the perpetrator of fraud. In the case of Enron, the Cayman offshoots were Delaware limited partnerships, managed and controlled from Houston, and the Cayman partnership LJM No 2 was defrauded of US$16 million. In the Parmalat scandal, the fraud involving a Cayman entity called Bonlat was also cooked up elsewhere; and investigators are looking at a veritable top global list of international banks and law firms mainly based in New York.

When it comes to pointing the blame for criminal activity, the so-called offshore centres can claim that they have taken an unfair rap. After all, you don’t need a remote island to get involved in criminal finance. Agha Hasan Abedi put the head office of his Bank of Credit and Commerce International in Luxembourg and ran its operations from London. Robert Maxwell used Liechtenstein, Abacha used Citibank for some of his money and Switzerland and the UK were destinations of choice. A whole string of US and European banks have all been named in the investigations into Parmalat. They have denied wrongdoing, of course.

The US International Narcotics Control Strategy Report for 2005 in its long list of countries that it fears may be prey for money laundering ranks Australia, Burma, Canada, China, Hong Kong, India, Japan, Russia, Singapore, Thailand, the UK and US among 55 “jurisdictions of primary concern” along with the Cayman Islands and the Isle of Man. In the second tier of “jurisdictions of concern” come Barbados, the British Virgin Islands, the Cook Islands, Iran and Vanuatu. Places like Anguilla, Bermuda and the Marshall Islands join New Zealand and Sweden as “other jurisdictions monitored.” The report is deeply suspicious of the potential for onshore money laundering.

Just to take the opening paragraph about one country at random, it says: “The Netherlands is a major financial centre and as such is an attractive target for the laundering of funds from a variety of illicit activities. Activities involving money laundering are often related to the sale of heroin, cocaine, cannabis or synthetic or designer drugs (such as ecstasy). Activities involving financial fraud are believed to generate a considerable portion of domestic money laundering. Much of the money laundered in the Netherlands is likely owned by major drug cartels and other criminal organizations and much of it flows through the formal financial sector...”
Even so, it may be difficult to throw off the pejorative overtones of being an offshore centre, not least because there is a wide variety of so-called “offshore” centres. In Sark, one of the Channel Islands, there are no motor cars and only 575 residents, but they hold a collection of 15,000 nominee directorships between them and one person has 2,400. In Bermuda, the British Virgin Islands and the Cayman Islands, there are hundreds of well-regarded banks, law firms and accountants actively doing business. On the other hand, the advertisements of some smaller centres would set alarm bells clanging in the least suspicious of minds: form an IBC with us, just US$1,000 a year; it can be done in minutes; we promise the utmost secrecy, so no one will ever know who you really are, and we will never tell any taxman. Such advertisements seem like a tailor-made invitation for any budding villain ready to embark on an empire of crime. Some critics say that these claims are strikingly similar to those of the very onshore US state of Delaware, where websites offer to set up a limited liability company in 24 hours by telephone, fax or online with only a single person needed and no need to show your face, with a wide choice of shelf companies for the picking.

Even with compliance mechanisms in place, there are plenty of loopholes to evade supervision. As an example, the IMF praised the Netherlands territory of Aruba for its efforts to strengthen banking regulations and anti-money laundering measures. But it found gaping holes especially as regards policing of corporate entities. The IMF commented that: “Offshore corporate entities are currently virtually unsupervised, are highly non-transparent with regard to ownership, corporate governance and financial condition, and thus remain a prime risk from a money-laundering perspective, as well as a potential financial sector vulnerability, insofar as these entities are involved in international financial operations.” In addition, the fund complained that there were 1,500 unresolved defunct entities – or almost a third – of the 4,950 registered offshore companies that had not been removed from the sector which “remain available for purchase without any form of scrutiny through the usual agencies or persons involved in setting up a company.”

A common theme through many of the IMF assessments is the need for more and better regulatory staff and for greater powers for the regulators. This applies particularly to the smaller centres. William Ryback, deputy chief executive of the Hong Kong Monetary Authority, had more than 35 years of regulatory experience in his native US before moving to Hong Kong. He was chairman of the bank supervisors for the Americas, which includes Central America, Latin America and the Caribbean. He has some advice for the small centres in the region: “In both Latin America and the Caribbean, much as local banks don’t have the ability to expand their balance sheets, supervisors don’t have endless amounts of money. What you are much better off doing is partnering together to supervise a geographical location. It does not make any sense to build up your staffs to deal with anti-money laundering efforts, credit controls, operational risk, all this panoply of supervisory talent that you need when you can’t have so many people on your staff. So by definition you can’t do a good job. It makes more sense for these offshore centres to band together and say, you concentrate on credit risk and you come over and look at my credit risk and I’ll do anti-money laundering and he’ll specialise in operational risk. Supervisors have to find better ways to partner and arrange their supervisory skill base so they are not duplicative but additive to a wider geographic location. [Jurisdictions] may not want to give up their sovereignty over supervision, but it doesn’t make any economic or financial or any sense to continue to compete when you don’t have any ability to supervise.”

Colin Powell of Jersey has advocated that the real distinction is between well-regulated and poorly regulated jurisdictions. “A number of jurisdictions dislike the use of ‘offshore’ because G7 countries and others have tended to use the term as synonymous with poor financial regulation and poor anti-money laundering and anti-terrorist financing rules,” he notes. “The distinction we would wish to see drawn is between cooperative and non-cooperative jurisdictions, or jurisdictions that are compliant or non-compliant with international standards rather than between offshore and onshore.”
In Powell’s view, there is a strong dose of self-interest in this because the well-run and well-regulated centres will attract the business: “In my view, the financial centres that will succeed are those that are well-regulated. Both large and small centres can meet this requirement. There is no reason why well-regulated offshore finance centres should not be able to carve out a future for themselves as niche market operators.” He suggests that if the established centres are well-run “with a wide range of quality services on offer, it will be difficult for a newer unproven finance centre to attract business. The latter may be able to attract some business, such as company incorporation on grounds of being much cheaper, but if it is tempted to compete by lowering standards of financial regulation, it is likely to find itself on lists of non-cooperating countries.”

John Aspden, chief executive of the Isle of Man’s Financial Supervision Commission, while admitting that life is never easy for an offshore centre, stresses that the main ambition of the island is: “We want to be regarded as a responsible international citizen.” He also believes that well-regulated centres with a broad base of services will flourish and attract funds – as the Isle of Man is proving.

Powell also believes that it is easy to get away with money laundering through larger onshore centres, “simply because the overall scale and wide range of the financial transactions undertaken in these centres is likely to mean that the transactions are less likely to be flagged up as unusual and suspicious.”

There is anecdotal evidence that this may be true and that notwithstanding Nauru, onshore is where to wash dirty money. In the UK, great pains are certainly taken to check the credentials of new and small customers. A Japanese went from the World Bank to do an MBA degree at a British university and tried to open an account with one of the big British High Street banks, which demanded letters from her Japanese bank testifying to her previous good record. The Japanese bank only had documents in Japanese, so the British bank demanded translations duly certified. In the end, she got her bank account when her World Bank boss testified to a director of the British bank that she was of good character. Yet a string of scandals from BCCI to Abacha show that it’s quite possible for doubtful big fish to evade the controls. If this is so in the UK where bank executives are careful, what happens in centres without such strong controls, like China, for example?

The challenge for the offshore financial centres in 2005 and 2006 is to make their case that they have been through the inspection processes and have been taken off the black lists. They have passed laws against money laundering, and have provisions enjoining strict “Know your customer requirements”. Given all this, they should be treated as respected partners in the dialogue over some pressing issues relating to on- and offshore finance.

Given that somewhere between US$7 and US$10 trillion worth of funds are held in offshore centres, they cannot be wished away as critics from Oxfam on the left to US senators on the right sometimes seem to want. There is sometimes a touching naivety among critics such as international charities who come up with a number for tax losses and assume that such sums could be collected and transferred automatically to the deserving poor, so that the world’s problems would be solved.

The world is constantly changing and the winners will be the ones who are flexible enough to welcome and embrace change. Even the City of London, the higgledy-piggledy Square Mile with its warren of streets with quaint names like Pudding Lane, Puddle Dock, Garlickhythe, Threadneedle Street, Mincing Lane, has constantly adapted to change. Older buildings, such as St Paul’s Cathedral, itself radical in its time, are overshadowed by modern plate glass blocks, and one of these, the “Erotic Gherkin”, Swiss Re’s headquarters in the city, looks as if it has dropped in from outer space. But by embracing change London has retained the global leadership of international finance.

The critics of offshore financial centres might do well to remember Adam Smith, who wrote more than 200 years ago that: “The proprietor of stock is properly a citizen of the world, and is not necessarily
attached to a particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business or enjoy his fortune more at his ease.” Many people have noted that there has been a steady fall in the relative contribution of corporate tax payments in the US and UK. In the US in 1960, corporations paid 24 percent of all federal taxes, a figure that fell to 12 percent in 1996 and had further fallen to a mere 8 percent in 2002. In the UK the tax take from business as a share of gross domestic product fell from 3.6 percent in 1996 to 2.8 percent in 2002.

Rupert Murdoch has been roundly criticised because his News Corp companies have paid so little tax, thanks to operating his empire through hundreds of subsidiaries. Murdoch evidently practices the art of tax avoidance well. But hosts of other companies, especially those with multinational operations, from Boeing to Microsoft, all use offshore centres to minimise the tax take of governments. Frank Sixt, the chief financial officer of Hong Kong-based conglomerate Hutchison Whampoa, argues in a subsequent article (see page 27) that it is the duty of a company to its shareholders always to minimise its liability. It may be a cause for scandal that some big and hugely profitable companies pay little tax to their home countries, but that must also reflects the legislation and tax policies in the US and Europe. Maybe it would be more realistic for the industrialised countries to reconsider the bases of their taxation and seek to impose territorial taxation – as Hong Kong does – rather than try to make multinational companies that are and have to be footloose face worldwide taxation because their origins were in the US or Europe.

Oxfam also blamed the offshore centres for encouraging money laundering and the plunder of national treasuries by dictators such as Abacha. But in most cases the offshore centres have been at best bit-part players in a chain where respected international banks and many onshore centres have had a bigger role.

As for outright crookery, the European Commission in a note to the Council of Ministers and the European Parliament in September 2004 pointed out that Parmalat had annual losses of between 350 and 450 million euros from the mid-1990s to 2001, yet the company accounts showed positive earnings. All four lines of defence had failed, said the commission. The first line of defence should have been Parmalat’s own internal controls, especially by board members; second, the auditors, backed by other advisors, including corporate lawyers, investment bankers and other financial intermediaries when advising how to set up special purpose vehicles or issue bonds or incorporate offshore; the third is supervision, especially across borders; and the fourth line of defence is law enforcement.

This European Commission note does touch on one of the sensitive issues that the financial centres have to face – how much information and on what terms are they going to share with other jurisdictions? Both the European Union and the US have thrown down their challenges.

One of the most controversial measures is the EU Savings Directive, under which from mid-2005 members of the EU will exchange information with each other about customers who earn savings in one member state but reside in another. The idea was that there should be an automatic exchange of information right across the union, but Austria, Belgium and Luxembourg objected from within – and Switzerland was unhappy from without – and other members, including offshore dependencies of the UK were unhappy that Switzerland was not included. So in the end, a compromise was applied whereby all but the three dissenters will exchange information and the three plus Switzerland will impose a withholding tax starting at 15 percent. The directive only applies to individual savings, but the critics fear that Big Brother is on the march and the directive is the thin end of a bigger wedge. British Crown dependencies are caught and some have opted for the withholding tax and others for information exchange. The Isle of Man has chosen the withholding tax but allows customers to opt for information exchange. Former British colonies, now independent, have been able to gloat that the directive does not apply to them.

In the case of the US, the Sarbanes-Oxley Act extends the regulatory reach across national borders and empowers them to move against any errant entity offering investment opportunities to US residents. This global reach of the US was also extended in December 2004 by the Registration Under the Advisers Act of Certain Hedge Fund Advisers, Rule 203 (b)(3)-2 of the Investment Advisers Act of 1940, instructing that from February 2006 hedge funds will no longer be able to shelter under the “safe harbour” that permitted the counting of individual hedge funds, usually limited partnerships of limited liability companies, as the ultimate client of the adviser. The funds are generally not registered because they are mainly distributed to sophisticated investors. But with the new rule, any hedge fund with more than 14 clients resident in the US, irrespective of its place of business or amount of assets, must register in the US and have a chief compliance officer and comprehensive compliance rules in place. Many people outside the US see this as the Securities and Exchange Commission interfering outside its own waters; but
PricewaterhouseCoopers notes, “the SEC sees this as a shareholder protection initiative”. And the US Congress also passed the over-arching USA Patriot Act in the immediate aftermath of 9/11 allowing US agencies broad scope for investigation and seizure.

Sharing of information is a sensitive issue not least because several offshore centres are still sore about the way that the OECD and its allies set about demanding it. Louise Mitchell, chief executive of St Vincent and the Grenadines’ International Financial Services Authority, complained that countries signed “Commitment Letters” to the OECD promising transparency and exchange of information in exchange for being removed from blacklists “with a gun to their heads”. She charged: “The OECD’s harmful tax project was based on the principle that countries could be forced into changing their tax policies based on the threat of sanctions or defensive measures. The project was flawed however in the following ways: it was not based on sound or tenable economic or moral principles; it was riddled with obscure concepts that lacked real meaning; its ‘name and shame’ approach was not conducive to cooperation but rather to hostility; and its list discriminated against offshore financial centres in that it was not based on a level playing field approach.”

Other small players echo similar sentiments. Edmond Toka, who is in the supervision department of Vanuatu’s offshore financial regulator, says the small centre felt the extreme lengths to which big industrialised countries would go in the efforts to combat money-laundering: “Several years ago, no country in the world wanted to trade with Vanuatu as the United States tightened its arms in its efforts to catch money launderers. The big boys’ net to catch the big fishes also caught small toothless fishes too. It took a big effort in resources to clear Vanuatu’s name and reputation and allow countries of the world to be able to trade again with Vanuatu.” He is concerned about Australia’s ‘Big Brother’ attitude, and comments: “The principle of state sovereignty is as old as democracy, but sometimes one wonders if this principle is inapplicable when it comes to the Pacific concept of ‘Big Brother’ looking over the shoulders of his small brothers. Aussie tax authorities will do everything in their powers to force offshore investors whom they consider to be attempting to avoid paying taxes to force them to pay up or face the full force of the tax law. It explains why Australia would want to have the Australian Federal Police present in a jurisdiction like Vanuatu with a population of only 200,000.”

Toka says it is not easy for his country, knowing that one misstep may cause the loss of 400 Vanuatu jobs in the financial centre plus the indirect tax revenues that financial services bring.

The improvement is that, as Colin Powell says, the offshore financial centres are these days referred to as “participating partners” by the OECD. When the OECD started its mission well before 9/11 to prevent harmful tax practices, Jeffrey Owens, the director of the organisation’s Centre for Tax Policy and Administration, was described in Time magazine as one of the top ten on the European financial “must lunch” list: he was presented as a one-man launderette, so to speak, who was going to get the stubborn tax havens to clean up their act. In those days, the financial centres feared that the OECD was crusading for uniform taxation. Even then, Owens declared in a 2000 interview with the OECD Observer that the mission was “not to restrain competition, but to restrain harmful tax practices that erode the tax bases of other countries... We define harmful tax practices by any of three operative criteria: lack of effective exchange of information, lack of transparency, and attracting business with no substantial domestic ac-
activities (e.g. ring-fencing) where coupled with low or zero tax rates.”

Though OECD and the financial centres are involved in a dialogue of partners, there is still much suspicion among them that the “level playing field” the OECD is seeking is one tilted in favour of its own members, especially since Switzerland and Luxembourg have an inside track. Arguments about the differences between tax avoidance – which is supposedly allowed – and tax evasion – which is illegal – in some ways resemble medieval debates about the number of angels that could dance on a pin-head, but they keep regiments of lawyers well paid.

The wider challenges for both the offshore centres and for the international regulators are the changes in the global financial patterns and how to cope with them. One issue is the increasing demand for Islamic financial instruments, for which there is not the regulatory framework in place.

PricewaterhouseCoopers estimated in mid-2005 that Islamic financial products are worth US$200 billion, and are likely to grow by 12 to 15 percent annually over the next ten years, and that by the end of the decade 60 percent of the savings of the world’s 1.2 billion Muslims will be in Islamic products. In principle there should be no fundamental conflict between Judaeo-Christian and Islamic ethics, but Shariah law prohibits charging of interest, and therefore Islamic financial products have to be based on equity or risk-sharing. The International Organisation of Securities Commissions (IOSCO) has acknowledged that international accounting standards and principles do not adequately capture Islamic transactions. A complicating issue is that Shariah compliance is itself complicated by the existence of a proliferation of supervisory boards that interpret Islamic law differently.

Indeed, there is a potential looming problem in the European bias of all the supervisory boards. As PricewaterhouseCoopers points out, 10 of the 13 members of the Basel Committee are European, and the European Commission and the European Central Bank sit on the committee. Representation on IOSCO and on the IAIS is similar.

Another change in global financial flows is the emergence of Russian millionaires as the primary European wealth management opportunity east of Switzerland. Scorpio Partnership, a UK wealth management consultancy firm, calculated in August 2005 that Russian multimillionaires have net liquid assets in the range of US$300 to US$350 billion.

But perhaps the biggest changes are coming from Asia with the rise and rise of China and India.
following in the footsteps of Japan, Korea and the other tiger economies. The Economist Intelligence Unit calculated that by 2009 personal disposable income in China would reach almost US$1.4 trillion, and India would add another US$1 trillion, and Indonesia US$192 billion. That is only at the personal level. In addition, there are lots of looming corporate opportunities for the world’s biggest country where equity market listings are dominated by state-owned enterprises that are less than transparent from an investor’s point of view. China’s equity market capitalisation at about US$150 billion is less than 10 percent of gross domestic product and less than bonds – about 20 percent of GDP – or bank deposits – 185 percent. (see PricewaterhouseCoopers Investment Management Perspectives, July 2005) Suggestions that China itself relax restrictions on its citizens setting up or investing in offshore vehicles can only give a further powerful push to the tilt to the east in global money flows.

All this represents a whole new world of opportunities and problems, not least for the offshore centres. It will be interesting to see if new centres emerge to cater for East Asian interests, just as Bermuda and the Caribbean centre won chunks of US business and the Isle of Man and the Channel Islands serve Europe and European expatriates, or whether the established centres can market their products more globally. There is still room for better marketing campaigns. Even in sophisticated Hong Kong, a sales manager of a leading trust company talked of “the Isle of Man and the other Channel Islands”, managing to divert the Isle of Man more than 400 miles from its home.

Mauritius made a good play for business from India, and it and the Seychelles now have an eye on China and East Asia generally. They are no doubt hoping to bank on the fact that no BVI or Cayman Island on China’s doorstep and that Samoa, in spite of its catchy slogan that you can set up a company yesterday (given the time difference and the international date line), is too far away and lacks the weight of all-round financial expertise that the two Indian Ocean islands are striving to create. But China of course has Hong Kong on its doorstep, a small territory “offshore” to the mainland by virtue of the promises of the “one country, two systems” agreement. Hong Kong has a dilemma here. If it is to continue to be offshore to China and to win the bulk of the mainland’s financial business, it has to be seen to be distinct and separate from China and its leaders prepared to stand up and say “No” to Beijing – and for Beijing to accept that “No”. Already there is a perception, reflected in the World Economic Forum competitive rankings, where the territory dropped from nearly top in 1997 to 28th place in 2005, way below Taiwan in fifth and Singapore in sixth place, that Hong Kong is getting too cosy with Beijing. Chief Executive Donald Tsang protested, of course, that Hong Kong retains its freedoms and the judiciary is independent. But Tsang may be too close to realise the damage that tinkering with the Basic Law has done in emphasising the perception that it is Beijing that really controls Hong Kong’s shots. If so, global money may migrate to where it feels it is really offshore.

A child’s guide to financial alphabet soup

• ATFOMOTO shows how international bodies love their alphabet soup. It stands for Anti-Terrorism (Financial and Other Measures) (Overseas Territories) Order 2002 and it comes from the International Monetary Fund report on the Turks and Caicos Islands (TCI).
• Bank for International Settlements (BIS) www.bis.org was set up by The Hague Agreements of 1930 to facilitate Germany’s payment of reparations after the First World War. Today it fosters international monetary and financial cooperation and serves as a bank for central banks. Its 33 members include Hong Kong and Singapore. It sponsors the Basel Committee.
• Basel Committee on Banking Supervision (BCBS) www.bis.org/bcbs/index.htm was established by the G10 (see below) central banks and provides a forum for regular cooperation among its member countries on banking supervisory matters, developing broad supervisory standards and guidelines and formulating statements of best practice in banking.
• Committee on the Global Financial System (CGFS) www.bis.org/cgfs/index.htm was set up by the G10 central banks to undertake systematic short-term monitoring of global financial system conditions, longer-term analysis of how financial markets function and to make policy recommendations to improve the way that markets function.
• Egmont Group www.egmontgroup.org comprises 101 financial intelligence units of most of the world’s big countries, though not China nor India, and most of the leading financial centres.
• Financial Action Task Force on Money Laundering (FATF) www.oecd.org/fatf was established in 1989 by the G7 summit in Paris and has drawn up a set of Forty Recommendations, updated in 1996 and in February 2002, and supplemented by nine Special Recommendations. It has 33 members, mostly OECD countries, but also including Hong Kong and Singapore. China has observer status.
• Financial Stability Forum (FSF) (www.fsforum.org) was convened in April 1999 to promote international financial stability, improve the functioning of markets and reduce systemic risk through information exchange and international cooperation in financial supervision and surveillance. Members are national authorities responsible for financial stability, mainly from the developed world but including Hong Kong and Singapore – but not China or India – plus representatives from the international financial institutions.

• Group of Seven (G7) is the club of rich industrial nations – Canada, France, Germany, Italy, Japan, the UK and US – that began to hold annual economic summits in 1975. The G7 finance ministers and central bank governors constitute the major forum for discussing economic and financial matters among the big industrialised countries.

• Group of Eight (G8) is the G7 plus Russia, which joined the Denver summit in 1997 and became a full participant at the 1998 Birmingham summit, but whose participation in G7 finance meetings is still uncertain.

• Group of 10 (G10) is the countries that have agreed to participate in the General Arrangements to Borrow, invoked if the resources of the IMF are estimated to be below a member’s needs. The G10 has had 11 members since Switzerland joined the original 10 (the G7 plus Belgium, the Netherlands and Sweden) in 1964.

• International Association of Insurance Supervisors (IAIS) www.iaisweb.org was set up in 1994 and is a forum for cooperation among insurance supervisors from more than 100 jurisdictions. It devised the IAIS Core Principles, the Insurance Concordat and has worked on developing standards in the areas of solvency, asset risk management, group coordination of financial conglomerates, reinsurance, market conduct and electronic commerce, especially in cross-border areas.

• International Accounting Standards Board (IASB) www.iasb.org.uk is an independent privately-funded accounting standard setter based in London working to develop a single set of high-quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. A total of 40 IAS have been promulgated.

• International Monetary Fund (IMF) (www.imf.org) was founded at Bretton Woods in 1944 with the World Bank. The jobs of the two organisations do not match their titles: the Bank is a development funding agency and the Fund is more like a global central bank watching over financial stability. The IMF carries out surveillance of the international monetary system, and it has developed international standards for transparency practices in fiscal, monetary and financial policies. During the Asian financial crisis of 1997, it was widely criticised for the stiff conditions it set as the price for countries to receive its loans. Critics claimed that interest rates, unemployment and misery were all exacerbated by the IMF’s conditionality.

• International Organisation of Securities Commissions (IOSCO) (www.iosco.org) is a body that promotes cooperation among national regulators of securities and futures markets, setting regulatory standards in order to maintain efficient and sound markets.

• KYC is perhaps the most important phrase for regulators and regulated alike, especially those in the financial sector, it stands for “Know your Customer” (except in the Cayman Islands, which has made a bid for its own separate identity with “Know your Client”). It refers to the need to know the pedigree of customers (or clients) and the provenance of their money to ensure that you are not giving a safe harbour to crooks, money launderers or terrorists.

• Organisation for Economic Cooperation and Development (OECD) www.oecd.org, is a Paris-based grouping of 30 member countries sharing a commitment to democratic government and the market economy. It aims to foster good governance in public service and in corporate activity and produces internationally agreed instruments, decisions and recommendations to promote the rules of the game. It also does individual country surveys and in 2005 produced its first review of non-member China.

• Patriot Act is itself an acronym (USA Patriot Act) for a law passed by Congress in October 2001 for Unit- ing and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism.

• Sarbanes-Oxley, shortened to Sarbox or SOX refers to the complex Sarbanes-Oxley Act of 2002, which amends certain provisions of the US Securities Exchange Act of 1934. It brings sweeping changes to the rules governing public company accounting practices and standards and imposes new responsibilities on executives, board members, audit committees, auditors and lawyers in order to prevent a repetition of the scandals of Enron and other rogue companies. It applies to all companies, big or small, domestic or foreign, that have registered under the Exchange Act. The complexity of its provisions is underscored by PwC’s discovery that its clients with revenues of more than US$15 billion had tested between 350 and 88,000 key controls (median 3,340), suggesting wide disagreement about what “key” means. It may make companies more inclined to go offshore, if they can. The European Parliament is considering similar “Eurosox” proposals.
There has been a lot of frustrated talk recently concerning the need to reform the United Nations system to make it better reflect the realities of power and influence in the 21st century world. In this process, talk of reforming the global financial architecture has been pushed to one side – which is a dangerous pity because the need for reform of the world’s financial system is also urgent. This does not just mean the G7 or G8, the global economic summit, or even the International Monetary Fund and World Bank. It also needs to involve the day-to-day financial architecture and particularly surveillance and supervisory systems.

At the top level of the economic summit, even the G7 expanded to become the G8 does not reflect the changing economic balance of power. On the one hand, Europe is over-represented. By what reason, other than the fact that they were founding members of the club, should France and Germany and Italy and the UK all have seats at the global summit? Surely, they are all members of the European Union, which should then be the European representative? But no, in the twisted logic of these meetings, the EU effectively gets a separate extra seat and the presence of the president of the European Commission and the head of the European Central Bank at these meetings further distorts the old-world flavour because France and Germany and Italy and the UK are all pushing their own national interests. In economic terms can Russia justify a place at the top financial table? How did Canada manage to reserve a seat?

China has already risen to be within sight of challenging Japan for economic leadership of Asia. In terms of the mere weight of trading and economic numbers China is already a giant. It may be a lot longer – and several crises later – before China effectively becomes Asia’s superpower simply because the quality will lag the quantity. But in 2005 China’s foreign exchange reserves, including those of Hong Kong, reached more than US$830 billion and topped Japan’s to become the biggest in the world. It was a symbol of the growing financial muscle of an awakening dragon. India, of course, is also awaking and in some international areas is already a more potent force than China.

Rodrigo Rato, the managing director of the IMF, warned in the preliminaries to the 2005 annual meetings of the Fund and the World Bank that Asia was underrepresented in terms of voting power and that it needed to be given more clout. But in the sclerotic way that the two institutions work, it is a big deal to achieve a mere 0.01 percent shift in any country’s voting power. The US is still ahead of anyone else at 17 percent, with Japan lagging far behind in second place on 6.13 percent, then Germany on 5.99 percent and France and the UK on 4.95 percent each. Saudi Arabia has 3.22 percent, China 2.94 percent and India less than 2 percent. Washington does not want its voting share to drop to 15 percent, when it would lose its effective veto power. Europe has 10 of the IMF’s 24 executive directors and 40 percent of the votes.

It is noteworthy that Rato drew attention to the need for changes because it is in the financial area where the risks to the global system are most evident. The Bank for International Settlements (BIS) and the IMF have drawn attention in their recent reports to the sheer volumes of money sloshing around in
the world system along with increasing volatility and the hungry search for better returns. According to the BIS, daily foreign exchange turnover in April 2004 was US$1.9 trillion, up by 57 percent in current exchange rates and 36 percent in constant rates since 2001. In the derivatives market, global daily turnover in foreign exchange- and interest rate-related products was US$2.4 trillion a day in April 2004, up 74 percent in the three years, or 51 percent in constant exchange rates. By the end of March the total stocks of cross-border claims of BIS reporting banks were US$19.8 trillion, of which US$12.6 trillion were claims on banks and US$7.2 trillion were claims on non-banks.

In the background are factors like the sharp rise in oil prices and US deficits and the dark grey cloud of pension funding in many countries, particularly in the West and Japan, whose populations are aging rapidly. This is leading to demand for new hybrid products that will yield higher returns – and also to the real danger that the regulators are not equipped to cope. The quality of leadership from the IMF and the G7 is poor. One US academic, Barry Eichengreen described the IMF as a “rudderless ship adrift on a sea of liquidity.”

The IMF at least is aware of the potential problems and drew attention in 2005 to the rapid growth of global financial assets held by non-bank institutional investors – to US$45 trillion in OECD countries, doubling in the last 10 years – and to the potential for turbulence as institutional and individual investors seek to maximise risk-adjusted returns by diversification to uncorrelated assets.

In this environment of immense tidal flows of money, it is depressing to get the knee-jerk reaction from officials and regulators who try – like King Canute – to order the waves of money not to go to offshore financial centres but to stay onshore and face whatever restrictions and tax burdens that they wish to impose. Whatever the wishful thinking of the industrialised West, it is unlikely that offshore centres will go away. Indeed, they are likely to become more prominent when the growing band of Asian wealthy corporations and individuals wakes up to the opportunities of diversity, including offshore jurisdictions.

At the same time, the offshore jurisdictions, especially the smaller ones seeking to cut corners and catch up with more developed places by offering cheaper solutions with lax supervisions, do need to be subject to surveillance. The Forty Recommendations plus nine Special Recommendations of Financial Action Task Force (FATF) are very much a work in progress, intended to be modified and updated. And it may also be a useful cautionary tale that although most places are off the black list, few have completely fulfilled all aspects of all the recommendations.

The problem is that in spite of the best efforts of regulators and the huge and increasing sums that have to be spent on compliance – and HSBC reports that working in 79 jurisdictions it has to deal with 370 authorities and spends 320 million euros a year in the process –, the regulators are rather like tourists having lunch on the beach as a tsunami approaches, ill-prepared for the size of the problem or the direction from which it will hit, especially as non-banks handle bigger sums and develop products that cut across traditional boundaries. Even in Europe, which is relatively developed financially, PricewaterhouseCoopers commented: “The regulation of asset management and funds is an odd hotchpotch. It owes much to competitive pressure, from stockbrokers who, back in the 1930s, did not want their clients attracted by a transparent, cheap product; and from banks, who did not see why investment managers should be allowed to run money, including cash, without a bank’s regulatory capital burden.”

There is an urgent need to create a financial supervisory body that encompasses all jurisdictions, and is aware of all the potential ramifications of financial flows including those that cut across traditional lines. The problem is that the IMF understands the issues and embraces most of the participants – with some important exceptions – but is still a prisoner of its 1944 power structure. Most of the other regulatory bodies are dominated by the OECD or European or Western interests. Adoption of the Basel II banking standards in the next few months will widen the gap between the banks of the developed world and those of the so-called emerging markets.

The important exception to the global IMF membership role is that Hong Kong is missing, along with the British dependent territories. Countries such as Barbados, the Bahamas, Belize and Vanuatu are members of the IMF but their voices are tiny. In the IMF and World Bank, Hong Kong is “the chair behind China,” to quote William Ryback, the deputy chief executive of the Hong Kong Monetary Authority
Failure to give Hong Kong its own seat at the global financial top table is a serious omission that reflects badly on the UK and the colonial authorities before 1997, on the Basic Law drafters, and on China after 1997.

After all, Hong Kong has its own membership of the World Trade Organization and the World Health Organization and other such bodies, so why could it not have been given a place at the IMF and World Bank? The plausible explanation is that the Bretton Woods twins were seen as direct bodies of the United Nations, and to join them a country has to have its own United Nations seat first, so Hong Kong occupied a chair behind the UK when it was a British colony and now occupies the chair behind China’s seat that the People’s Republic took over when the previous occupant, the Republic of China (Taiwan) was ousted from the UN and its agencies. Hong Kong’s emergence as an important financial centre, of course, only came only after its rise to become a major global trading city. But it is a major failure of the global system that Hong Kong could – rightly – join the WTO in its own right, but could not be considered for its own seat at the IMF.

Even so, imaginative authorities – both in Beijing and on global matters – would have appreciated that Hong Kong has special expertise as an international financial city not found elsewhere. It is certainly not found in Beijing, where the command economy still rules even as private enterprise is flourishing. Curiously, the IMF in its seminal report of 2000 cited London, New York and Tokyo as international financial centres, but not Hong Kong. This was a major omission, especially since international activity in Hong Kong is greater than Tokyo.

All this makes it difficult now, especially since initiative and imagination are the two qualities most lacking in international fora. If Rato and the IMF want to advance a radical solution, they would propose Hong Kong for a new hybrid observer-member role at the Fund and give the territory special responsibility for devising a formula and rules for modern international financial centres – on- and offshore – and able to comprehend the traditional barriers between banking and securities, funds and insurance. After all Hong Kong is unique: a huge international centre of finance; the financial key to China; and still regarded as an “offshore” centre by international bodies. Let Joseph Yam, the chief executive of the HKMA show his special experience and expertise and justify his salary as probably the best-paid central banker in the world. Other financial centres, including London, Luxembourg, Singapore, Switzerland, Tokyo, British Virgin Islands and the Caymans plus the smaller independent islands should join the work. With all its faults, the IMF is probably the best host for such a body since it is truly international, unlike FATF, the Basel Committee and others.

Beijing would no doubt be suspicious about giving autonomy to Hong Kong – in spite of the grand promises of “one country, two systems”. But China should also be embraced by the global economic powers and promised a seat at the G7 table expanded to become a G12 and allowed to take its turn in chairing the proceedings. (Whether the G12 – the seven plus Russia, China, India, Brazil and South Africa – should subsume the G8 would be open to argument: the G8 could continue to talk politics while the G12 or G11, without Russia, discuss economies.) It is easy to understand why the G7 have been reluctant to extend a formal invitation to China. It is not a market economy, in spite of the growth of the private sector, and its currency is not convertible. Equally important in the eyes of Japan and the US in withholding an invitation to Beijing, China is not a democracy.

But it is necessary for the world to have a dialogue with China and for China to learn about the world before it is too late. And there should be room for Hong Kong to have a little autonomy and to demonstrate to Beijing that there are some areas where the colonial offshoot can teach the mother country the way to the modern world, even if the timid rulers of the Chinese colony no longer have the confidence to stand up to their new colonial masters the way Hong Kong was once proud to stand up to the UK.
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Jeffrey Owens, the director of OECD Centre for Tax Policy and Administration, argues that good regulation is the key to being a strong player in international finance.

The Asia-Pacific region continues to exhibit strong growth, with wealth creation far exceeding that in other regions. The region is characterised by fierce competition, particularly in the private banking sector. Banks and financial institutions are targeting investors and wealthy individuals. In 2004, individuals with at least US$1 million available for investment grew by more than 8 percent. The number of billionaires in the region is also growing.

Although the private banking sector remains largely fragmented, over the last five years the industry giants such as HSBC, CitiGroup and UBS have expanded significantly. At the same time, a number of smaller European private banks, particularly from Switzerland, have entered the market. All of these players are looking for niche markets and targeting the most lucrative market segments. The most rapid expansion is taking place in Singapore, which is offering itself as an alternative to such traditional private banking centres as Switzerland, Luxembourg and the Channel Islands. But financial institutions, large and small, also realise that they must have a presence onshore, including in such highly regulated markets as Japan and China.

These developments in the region have to be seen against the global expansion of offshore finance. The Cayman Islands, Bermuda, Barbados, the Channel Islands, Gibraltar and many other offshore financial centres (OFC) have also grown rapidly over the past three years. Interestingly, many well-regulated centres like Jersey, Guernsey and the Isle of Man are seeing the highest rates of growth. (Assets under management by Jersey grew by 12 percent in 2004; Guernsey’s fund servicing increased by 22 percent and that of the Isle of Man by 8 percent.) The Cayman Islands is now the fifth largest centre for bank deposits worldwide and Singapore has become third largest centre for private banking. Simultaneously, there has been a rapid increase in the number of offshore financial centres: 30 years ago there were fewer than 15 such centres; today there are more than 45, a number that continues to increase as small countries with weak economies try to move into the financial arena. Many of the OFCs have come to be major players in international financial markets.

This process of liberation and expansion of OFCs has led to greater competition between financial institutions, lowering the cost of capital, improving the allocation of funds between countries and opening up new innovative financial arrangements that may not have been possible or profitable onshore. And yet there is a downside.

Money laundering, misuse of corporate vehicles, terrorist financing, tax crimes, and other inappropriate exploitation of badly regulated financial markets for personal gain all flourish in this new environment. Today the potential for financial abuse can threaten the strategic, political and economic interests of sovereign states. Widespread financial abuse undermines the integrity of the international financial system and raises new challenges for policymakers, financial supervisors and enforcement agencies. In certain jurisdictions such abuse may go so far as to undermine the democratic basis of government itself.

Financial crimes thrive in a climate of secrecy where normal good governance measures are undermined by a lack of transparency and a failure of financial centres to cooperate effectively with the law enforcement agencies of other countries. And, of course, behind this veil of secrecy there is a darker reality. Terrorist networks, arms dealers, drug traffickers and other international criminal syndicates exploit secrecy and non-transparent arrangements to legitimise the profits from their illegal businesses.
Poorly regulated financial markets not only open up new opportunities for financial crimes but can also threaten the stability of the international financial system.

As new technologies reduce the importance of physical proximity to major on-shore financial centres so a new generation of offshore financial centres have emerged. Remote jurisdictions with few natural resources and too remote to benefit significantly from the global economy have established OFCs – often with encouragement from international institutions and bilateral donors. Many of these OFCs have identified niche markets, e.g., captive insurance, offshore trusts – where light regulations coupled with cost advantages have enabled them to thrive. Others have targeted investors who are more interested in anonymity by offering strict bank secrecy, criminal penalties for disclosure of client information and a policy or practice of non-cooperation with law enforcement agencies of other countries.

Enron, Worldcom and Parmalat have all revealed serious weaknesses in corporate governance and in certain market functions. Such scandals have lead to a massive destruction of financial wealth. Incentives were misaligned and key checks and balances failed. Market participants tolerated, and in some cases contributed to, deceptive practices. All this reflected shortcomings in good corporate governance needed to ensure investor confidence, economic dynamism and competitiveness. The quality of corporate governance serves as an early warning system to corporate and financial problems.

Clearer transparency and accountability are especially critical for law enforcement and taxation authorities to do their jobs. An economy characterised by high standards of transparency and one in which members of management are accountable to their boards and the boards are accountable to their shareholders – including minority shareholders – is one where financial fraud and other financial crimes, including tax crimes, will be less likely to flourish.

Governments have responded to these threats by developing legislation to detect and deter financial crimes and by strengthening their law enforcement and tax enforcement capacity. Money laundering has been criminalised. Financial institutions are required to report suspicious transactions. Stricter regulatory and supervisory measures have been put in place. Access to beneficial ownership information and trust formation rules have been revisited and strengthened.

These national initiatives are reinforced by multilateral actions. OECD countries took the lead in developing new international tax standards (see Box). In 1992 the Financial Action Task Force (FATF) was created to counter money laundering. It developed criteria to identify non-cooperative jurisdictions and establish recommendations which guide governments in their fight against money laundering and, at a later date, terrorism financing. In 1997 the Financial Stability Forum was established to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance. It also compiled a list of poorly regulated OFCs which threatened the stability of the international financial system. In 1998 the OECD launched its effort to address the problems raised by tax havens as part of a broader initiative to counter harmful tax practices. Key features of this initiative are the promotion of transparency and effective exchange of information.

Each of these initiatives recognised that unilateral actions are insufficient. Each was launched by countries committed to high standards of financial integrity. Although each initiative was separate, dealing with distinct issues and encompassing different country groupings – both OECD and non-OECD – all were directed at establishing new international standards and within similar time frameworks.

The success of these initiatives can be seen from the way in which OECD and non-OECD countries are now working together to implement these standards. Today OECD countries have criminalised money laundering and are in broad compliance with the FATF recommendations. Many non-OECD countries have followed this lead. The FSF has been successful in promoting new supervisory standards. But the response to these initiatives has perhaps been most dramatic with regard to the OFCs. Today almost all of the OFCs identified in the FATF original list have been removed and 33 of the tax havens identified by the OECD in 2000 have committed themselves to the principles of transparency and effective exchange of information and, in many cases, now have more transparent rules that some onshore financial centres.

Considerable progress has been made by the OECD in the tax area, which is important since tax continues to be a major, but not the only, driver to use OFCs. The OECD has succeeded in creating a Global Tax Forum in which all financial centres – onshore and offshore – can engage in a meaningful dialogue. This dialogue is a true partnership and recognises the role the OFCs now play in the international financial system. The forum is jointly managed. Issues such as the level playing field are addressed.
New standards to promote fairer tax systems

The more open and competitive global market has had many positive effects on tax systems. Tax rates have generally fallen and tax bases have been broadened. Some tax and tax-related practices, however, undercut the gains that tax competition generates. This occurs especially if some countries engage in practices that encourage non-compliance with the tax laws of other countries. The ultimate losers are honest taxpayers.

They end up paying for dishonest practices by shouldering a greater share of the tax burden, and their confidence in the integrity and fairness of their tax systems, and in government in general, declines. Since 1998, the OECD has coordinated action so that countries – large and small, rich and poor, OECD and non-OECD – can work together to eliminate harmful tax practices with regard to geographically mobile activities, such as financial and other service activities. The concrete results of the OECD's efforts are reflected in the fact that of the 47 tax regimes identified as potentially harmful in 2000, all but one – the Luxembourg 1929 holding group – has been dealt with and in the commitments to transparency and effective exchange of information which have been made by offshore financial centres.

The OECD Principles of Corporate Governance, issued in 1999, have become the international benchmark in this area. They cover six main areas: the legal and regulatory framework for effective corporate governance; shareholders rights; equitable treatment of shareholders; the role of stakeholders (employees, creditors, etc.); transparency and disclosure, responsibilities of the board.

Corporate vehicles and trusts can be misused to facilitate financial crime such as money laundering, bribery, fiscal crimes, improper self-dealing and market manipulation, as well as terrorist finance. The critical concern is the potential for anonymity provided by the veil of a separate legality, which may be strengthened in certain jurisdictions by stringent secrecy laws and the availability of instruments that obscure beneficial ownership. The OECD produced a report giving a menu of alternative approaches that a jurisdiction could adopt and then a template that could be used for assessing a jurisdiction's capacity for obtaining ownership and control information and sharing that information with authorities of other countries. The Financial Action Task Force (FATF) was established in 1989 to combat money laundering around the globe. Following the events of September 11 in 2001 the FATF began waging a financial war on terror as well. The members of the FATF have committed collectively to follow a set of “40 Recommendations”, which were revised significantly in 2003. The FATF has also agreed to eight special recommendations to counter terrorist financing. Since 2000 the FATF has undertaken an initiative to help ensure that all significant financial centres adhere to international anti-money laundering standards. This initiative on Non-cooperative Countries and Territories (NCCT) has triggered significant improvements throughout the world. Some 23 jurisdictions were placed on the NCCT list in 2000 and 2001. Today only six remain on the list, and of these five have enacted significant reforms.

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The biggest offshore centre of all

Deputy chief executive of the Hong Kong Monetary Authority, William Ryback, addresses tricky questions of money laundering, terrorist financing and Hong Kong’s rise and rise as China’s financial centre.

There is one dirty word, really filthy, in the vocabulary of Hong Kong’s senior financial officials. It has eight letters rather than the conventional four of ordinary people when they resort to bad language. It is the word “offshore”. Joseph Yam, the chief executive of the Hong Kong Monetary Authority, gets particularly upset about the word. Partly, it is just that “offshore” is such a taboo in the minds of financial regulators, suggestive of a dark and dirty place beyond the rainbow of the regulators’ reach, where wicked deeds are done. The fact that bad things have gone on in some offshore places just makes it worse for a place like Hong Kong, which considers itself an exemplar of good financial policing.

Yet the fact has to be faced – that not only is Hong Kong considered “offshore” by many businesses, but it is also officially declared “offshore” by the international financial authorities, such as the Financial Stability Forum founded by the G10 governments after the global financial turmoil of 1997. Yam lamented in his regular e-mail letter in 2004 that regulatory authorities “consider offshore financial centres to be a problem in international finance, in that the standard of financial regulation in those centres is generally inadequate…” The Financial Stability Forum went so far as to embark on what Yam called a “name and shame” exercise in 2000 and listed the offshore centres. Regrettably, continued Yam, Hong Kong was on the list. “Efforts to get our name off the list have been unsuccessful, although we have from the start been honoured with a Group One status.”

William Ryback, who is Yam’s deputy, also complains that Hong Kong has been lumped into a category to which it does not really belong. It does seem silly to put the Cook Islands, Samoa or even Jersey and the British Virgin Islands in the same category as Hong Kong. The offshore centres are a very mixed bunch anyway, but Hong Kong is a place apart, a powerhouse of international finance, in the same league as London and New York and more international than Tokyo. Ryback regards the decision as a failure of imagination by the international authorities: “We were lumped into this offshore category years ago, partly definitional through the IMF (International Monetary Fund) and BIS (Bank for International Settlements) and statistically we report that way.

“At periods in its history the offshore centre has taken on a lustre that has not always been positive,” adds Ryback, underlining Yam’s objections in a gentler way. He agrees with the key distinction that Colin Powell, chairman of Jersey’s Financial Services Commission has tried to make in assessing offshore centres. “Over the last couple of years Colin Powell has initiated a discussion among all the countries, saying that the issue here is between compliant and non-compliant jurisdictions, and to use ‘offshore centres’ with the connotation that they have lesser standards than other financial centres globally is just wrong. I am solidly in his camp. I think that is the issue.”

But for Hong Kong itself, Ryback makes the demand that its growth and role is so big that it should be placed in a fresh category. “I agree that it is time for a rethink. We have been suggesting the idea that there should be a category of international financial centre. But we don’t push that in a hysterical way. It
is just a notion that we think suits some jurisdictions better, including Hong Kong. You could put Switzerland in and a number of others, New York and its international financial centre activity, which is captured separately. One could be a little creative here.” However, Ryback sadly admits that global regulators and keepers of financial statistics are not in a very creative mood: “I do not sense that there is a strong statistical interest. And to be sure Hong Kong is not running around the world screaming in a loud voice that everybody has us wrong.”

Ryback was a regulator in the US for 36 years, much of it with the US Federal Reserve and was the Fed’s representative on the Basel committee on banking supervision for eight years before going to Hong Kong. He judges that efforts to produce a cleaner, better regulated offshore marketplace have been successful, not least because there is only one place remaining on the blacklist: “One of the islands out there remains. Nobody in their right minds would be doing business with them anyway.” In an almost folksy American way, Ryback mixes some cynicism with unexpected sympathy for the small genuine offshore centres. Some of them, he suggests, had persuaded someone with a good reputation to make recommendations, which they then passed into law, and thus by brandishing their new powers they got off the blacklist. He adds that there’s little point in being a renegade and certainly not when the big financial guns of the world are trained on you.

However, he is sympathetic towards the offshore jurisdictions at the bullying way the big financial players operated: “A lot of these countries were annoyed, concerned, upset that they were put into these arbitrary categories from the get-go, from the beginning, and had to work their way out of it. Then to be told by the Financial Stability Forum that we are not going to modify the list, we are just going to let it hang out there, annoyed people even more. There was a lot of energy being put in that direction, not that I expect there was tremendous money laundering going in to these jurisdictions.”

It is certainly good that supervision has been tightened under international pressure. Ryback relates a discussion at the BIS where the representative of one of the offshore centres said that small geographical entities had to juggle with limited resources. “The then head of the BIS responded that if you can’t supervise it, don’t license it – which means that you should scale down your ambitions to be a global financial sector to match your ability to supervise,” relates Ryback. “There is a lot of concern that there was mischaracterization, that there was not a proper grading exercise that started this. But I think it is safe to say that now that it is all done, hopefully it is a better world,” he concludes.

Pressed on the issue of money laundering, he says that the claim is sometimes made, “that it is very difficult to launder money in these offshore jurisdictions because they are too small. It is like parading an elephant down Main Street and saying don’t look.” But does he agree? “To be honest,” Ryback responds, “I don’t know. It sounds plausible to me. I know it’s the way in which those offshore centres were supervised for tens of years since the Bank of England got most of the supervisory jobs, you know, with a heavy dose of the old Bank of England approach – to rely on the market to identify those bad characters, to ferret out the real bad end of the spectrum and not to spend a lot of energy on onsite supervision.”

On the other hand, he cautions that, “What surprises me is that every single known case of money laundering that has ever happened anywhere in the globe is so great that it is a case of the elephant down Main Street. Take Sani Abacha – a Nigerian dictator putting a billion dollars in his account when he gets $50,000 a year. Doesn’t someone stop and say, ‘oh my gosh, this doesn’t make sense.’”

Every case of money laundering... is the elephant down Main Street.
Abacha - a Nigerian dictator putting $1 billion in his account when he gets $50,000 a year. Doesn't someone stop and say, 'oh my gosh. This doesn't make sense.'

But they are all fighting and clamouring for business.”

Ryback says there are plenty of problems in trying to combat money laundering: “I happen to think that the problem with money laundering is always the second tier stuff – which means wire transfers – and this is where there is considerable energy being focused now.”

Law enforcement authorities have long argued for much more information on international teleaxes than the industry was willing to give, with banks claiming there were limitations on the information that can be put in the number field. But resistance has become more muted after the 9/11 terrorism and more recently the bombings in London.

Nevertheless, Ryback retains a sense of scepticism about whether the measures are the right ones. Efforts were made in the United States to get reports on currency transactions below the level of US$10,000. But at this level, he says, “you are getting to the point where people making transfers for their kids’ education become wrapped up in all of this and people get annoyed. ‘Why do I have to go to the bank to pay for my daughter’s...
college education and have to tell the law enforcement people a whole bunch of stuff’ they ask.

“For all the effort that has been put into financial transaction reports, they have never caught one
money launderer yet, not one, not one,” he repeats. “Where they are useful is when they catch a money
launderer to go back and look at the series of transactions and to have that kind of evidential information
to take to court. But so far as anyone is concerned rummaging through these reports and saying, ‘My God, I
have a money launderer,’ it has never happened in the history of time.” The obvious solution, he suggests,
is to keep records for five years, but not to require formal reports.

Ryback points out that however good your system, you can always make it better – which is why
Hong Kong is looking at bringing in an omnibus bill that will involve accountants and lawyers as well
as the traditional bankers and financiers. But it is inevitable that there will be tensions and trade-offs
since not everyone is looking at the problem from the same perspective.

“Let’s take a bank examiner,” Ryback says from his more than three decades of experience, “you
never come out with a completely clean report, never. I don’t care how clean the bank is, you’d better find
something, so that if anything blows up, you can say, ‘Hey, I was looking at it.’

“[We are] still in the talking phase [of Hong Kong’s omnibus bill] and we will make some progress
soon. The intention is to strengthen the money laundering provisions. There is no sense in staking out
a position. You have to make some progress because you have to maintain your position as a strong
financial centre.”

But asked about his own views, he starts with a long sigh: “I have a history of being drawn into this in
the United States, where, no matter how much time, energy and effort you put in against money laundering,
Congress never thinks it is enough, nor does law enforcement. You have a lot of things to take care of, and
you do not want to be negligent on any of them. In the absence of any information that there is hard money
laundering going on [here in Hong Kong], which I don’t think there is, I am content with where we are. We
can always make improvements, which we will always look for, and the omnibus bill is a perfect opportunity
to do that, but right now I think that we have a fairly good anti-money laundering effort.”

He points out that after 9/11 a fearful new dimension was introduced: “Money laundering and terror
financing are two very different things,” which makes for new tensions between the authorities and the banks.
“In money laundering you are looking for little bits of information that help you to aggregate and identify the
launderer or the criminal. In terrorism, you are looking for big pockets of money that are being put through
ATMs in little bits of $100 or $500 – and that is very, very difficult to deal with. Generally the view is that we
need to find different mechanisms. Right now we have the list [of suspected terrorists], which is about all that
is effective, that comes from the UN and other sources that identifies the latest names on the list. That is a pain
in the neck. Banks have to stop and go through the filters. The names could be similar but not the same. The
banks argue, and I think it is not wrong, to say that, ‘If I do a good faith effort, I want to be in a safe harbour.’
But [law enforcement replies], ‘No, if that happens in your institution, you are in trouble.’

“I have sympathy with them because if they identify someone, the law enforcement people will not say
that’s a hit or that’s not a hit. In the US everybody is filling in currency transaction reports because they are afraid
that the examiners are going to beat the hell out of them. The US state attorneys general kinda went
off the reservation and thought this was a neat way for them to make political statements and get their
names in the papers so that they could run for higher office. The department of justice stepped in and said
you have stop this stuff – because banks were filing everything that moves [and saying] you sort it out.
Currency transaction reports have increased exponentially.”

For all the difficulties, Ryback believes that progress is being made: “We are making progress in looking
at topographies, looking at how this stuff is being done, seeing a pattern, how those patterns are repeated
in different jurisdictions. That requires a lot of trading of information. From the bankers’ side, they are
still a little annoyed that they don’t get robust feedback from the spooks or from the law enforcement
folks. They on the other hand claim that they have got a lot of supersecret stuff to do, with a lot of
supersecret money around the world, so they cannot amplify too much. Gradually, the cooperation is
coming, energized by the terrorist side of the equation. It does not make any sense to have a subway blow
up and say, well it could have been prevented if someone had told the banks,” he adds.

For all the dislike of the word “offshore” because of its negative connotations of regulatory arbitrage and
escaping from onshore controls, Ryback rejoices that, “Hong Kong is an offshore centre for China, and will
[become more important] as time goes on and liberalisation takes place and they back the screw off half a turn.
Hong Kong will be the outlet for that, otherwise you will have chaos.” Development may be slow, but “there
will have to be a natural place for futures and derivatives transactions to begin to take place, and Hong Kong

Ryback rejoices ... Hong Kong is an offshore centre for China ... Hong Kong will be the outlet, otherwise you will have chaos

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is as logical as any. It depends upon the speed at which China wishes to move along the scale of convertibility. They are doing that. The latest round of actions would suggest that. I have no idea about timing.

“Hong Kong is in the advent of pushing the markets. We are certainly building the infrastructure of a payments and settlements system. The only piece that is left of that is a renminbi settlement infrastructure, and that will come in time. We are the only place that offers same day settlement of all the currencies – Shanghai does not and no other place does. We are actively building that infrastructure for the day, [following] the old saying that, ‘if you build it, they will come’.

“We need to develop the alternative markets, and China understands that, otherwise all the risk gets clogged up in the banking system. We should have debt markets out there that function better than they do now. They function, but they certainly are not vibrant and deep, which does not then lend itself to dealing with the derivatives part of this. We have plenty of sellers of credit risk, a number of institutions that are very active, but there is nobody buying. Unless you have a two-way market, it doesn’t work. The reason you have periodic crises is that all the risk gets backed up in the banking system, the plumbing gets clogged.

“In terms of hard banking, we have a lot of trade transactions here and service the local market through the retail and the commercial market. We are also the clearing house for most of the in and out into China. It is much easier to do it here than in Shanghai. The IPOs keep coming here.” This helped to propel Hong Kong to third place in the global IPO league in 2004, after New York and Madrid.

One thing that Ryback really appreciates is the cooperative way of doing business between the various authorities in Hong Kong, a sharp contrast with the political games played in the US: “The beauty of this place, which really was enlightening and eye-opening when I came was the way people work together. There are little disputes but always resolved at the appropriate levels. It works here much better than in the US where there is a lot of self interest and people wanting to play king of the hill and lobbing grenades at one another. The way you get ahead is to make someone else look bad.

 “[Congress exacerbates the conflicts.] They love it. Get three or four regulators there and [someone] throws in a grenade in the room to watch where it rolls. I remember going up [to Capitol Hill] with a governor [of the Fed] and saying to her, ‘All you have to do is keep your mouth shut. We don’t have a dog in this fight, so just let the FDIC and the OCC duke it out, so you just keep quiet.’ But no, no, she had to stand up and say her piece and the next thing I know all this energy is going off in the room and I am getting a lightning rod and oh ma’am, you just dictated my weekends for the next six months.

“Here, if you have a problem, you just call somebody up and say, ‘What do you think?’ Here there is a common agenda. Part of the reason why I admire China so much is that they will debate an issue until they get everyone in the same circle. Yes, you can argue this is clumsy execution of public policy because there is not a defined road map of the way to go but I think it part of the public policy debate.”

Hong Kong’s relationship with the mainland is such that, according to Ryback, “We are joined at the hip with China.” Even so, Hong Kong has to work to stay ahead of the game: “We need to be mindful that we keep building the infrastructure to maintain a reasonable place in the world waters. We whacked through legislation a year and a half ago on a payments and settlements system that brings us up to standard, up to code. The only element left is to set up renminbi clearing at the appropriate time. Now renminbi goes into the Bank of China and back home. As you move along the scale of convertibility, you don’t want to have that happen on day one without the infrastructure to deal with it on day two. Nobody has told us to stop. A lot of partners have to be involved.”

But renminbi settlement is not the only issue. There is a range of issues where financial cooperation has to be built between Hong Kong and the mainland, especially in the Pearl River delta. “We have to extend the thinking of our institutions to tell them there is a whole region out there to swim in,” Ryback says, taking the region into his purview. “That’s a problem because we have not yet expended appropriate amounts of energy in trying to build a common infrastructure for banks to operate in... There are different rules, different capital calculations for different kinds of instruments. We need to look at how much we can harmonise our regulatory platforms. That again is one of the areas where if we build them, they will come. With Macau as the western epicentre and ourselves as the other point on the compass, the whole Pearl River delta is going to be a polyglot of financial services, including Shenzhen and Guangzhou. Financial borders are being eroded faster than physical borders. [The speed at which it happens] is up to China.”

Kevin Rafferty
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It must be blue chip all the way

CFO of Hutchison Whampoa, Frank Sixt, describes the sky blue rules of offshore finance for a multinational group

F rank Sixt (right) has a favourite word, which any banker, accountant, lawyer, financial adviser and, particularly, any official of an offshore financial centre dealing with him ought to be acutely aware of. The word is “blue chip”. He used it more than 20 times in an hour’s discussion – as both a noun to emphasise that Hutchison Whampoa, the Hong Kong conglomerate of which Sixt is chief financial officer, is a blue chip and as an adjective to describe the way that it behaves in raising funds and paying taxes, always in a blue chip way.

Hutchison has an enormous global outreach, both geographically and in terms of businesses. It operates in 51 countries (counting Hong Kong, Macau and Taiwan as part of China) and has more than 2,000 companies under its umbrella. It is the world’s largest private container port operator, handling almost 50 million boxes a year of the industry standard twenty foot unit in ports from Hong Kong, China, Korea and Indonesia, to Felixstowe, Harwich and Rotterdam in Europe, Panama, the Bahamas, Mexico and Buenos Aires in the Americas and Saudi Arabia and Tanzania in Africa. It has 10,500 hotel rooms, 56.8 million square feet in property managed and another 48.7 million square feet in properties under development. It produces 91 million toys, 716 million litres of distilled water and has 6,800 retail stores in 33 markets. It produces 325,000 barrels of oil a day through its 35 percent owned Husky Energy. Most recently, it has ventured extensively into telecoms services, for which it has 21.4 million customers.

In 2004 Hutchison Whampoa had turnover of HK$179.4 billion (US$23 billion) and profit attributable to shareholders of HK$16.1 billion. As CFO, Sixt is responsible for managing long term liabilities amounting to HK$255 billion at the end of 2004 as well as liquid funds of HK$67 billion. He is well acquainted with offshore financial centres, not least because Hutchison has companies or financial vehicles registered in the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, Luxembourg and the Netherlands Antilles, as well as its home base Hong Kong.

But Sixt starts off by denying that in his vision of the financial markets any such specific thing as an “offshore centre” exists. He plunges straight in: “I am not sure that there is any such thing as an offshore centre as a category… The global guidelines for a CFO are that one limits liabilities wherever one can.”

The global guidelines for a CFO are that one limits liabilities wherever one can. It is very much driven by what is the best at the end of the day in terms of creating value, preserving value for our shareholders relative to any particular business of ours around the world or indeed of any particular facet or aspect or service components of one of those businesses. That has us in the market for trying to understand the rules governing taxation and incorporation everywhere in the world really. The only touchstone is – as with anything else you do in a blue chip multinational – it has to be done in a blue chip way. We have no interest whatsoever in associating with jurisdictions, even if they might offer an advantage, if they are viewed as being substandard in terms of their international norms of conduct. That is simply just off the radar screen.
for us. It becomes quite important that the rules and the administration achieve our purpose on the one hand, but on the other hand be and are seen to be very, very blue chip. The corollary to that is that when we are dealing with offshore incorporations anywhere, we expect to be dealing with the same world-class institutions and with the same world-class financial professionals. The reality is that some places that seem to fall into the category that people describe as offshore centres simply do not have reputable international institutions for whatever reason or do not have international standard professional advisers for whatever reason. In that case, they are just not on our list in the first place.”

The fact that there are so many companies within the group has a driving force of its own. Sixt continues: “Remember that there is a primary objective from the get-go which does result in a multiplication of corporate entities and that is limited liability. It is axiomatic in doing business around the world that you want to the greatest extent possible to limit your liability exposure to whatever relates to that business as opposed to essentially offering up the very deep pocket of the parent company. That becomes more true the more potentially litigious the places are where you are doing business. We all know that the world is different and some places are more litigious than others. In our business, we often also focus on maintaining the highest degree of control possible. Thus, rules on board and board committee composition, the eligibility of non-residents or non-nationals to serve as directors and, of course, the quality of corporate regulatory, securities regulatory and commercial court practice, and experience will often lead to a decision to choose one jurisdiction for incorporation over another.”

Given its blue chip status and its blue chip behaviour, adds Sixt, Hutchison Whampoa has no direct experience of the clean-up operations that the Financial Action Task Force and other bodies have been trying to ensure. He says: “It is a corollary of taking a blue chip approach and working with the best institutions and advisers that I do not think that we ever are or ever have been or would ever expect to be in the range of conduct that is targeted by this kind of clean up. I can put my hand on my heart and say that we have never shopped for a tax treaty. If there has been an opportunity because we had a business there and there was some advantage for that business to hold an interest in a business here, then that’s fine and we would take advantage of it. You approach the whole business of organising your affairs for tax purposes – which we do have to do, we should do, on the basis that minimising the effective taxes is as legitimate an objective for this company as minimising any other category of expense relative to our shareholders. But you never go even close to the line that takes you in the direction of tax evasion away from the safe ground of legitimate planning to manage tax and compliance burdens.

“The more blue chip institutions and advisers you deal with, the less you tend to test the limits. I have not found that any of the changes that have been wrought as a result of the OECD and others has actually impacted us at all. I suppose we were not worried about some of the same things anyway.”

Sixt recalls his own past as a factor that reinforces this blue chip behaviour: “For my sins, I am doubly cautious in this area because I used to be a tax lawyer a very long time ago – and one thing I learned very early on about any kind of ordering of your affairs to mitigate the effect of taxes is that frankly there are things that are legitimate because they smell legitimate and there are things that are not legitimate because they don’t smell legitimate. The reason why we use the best advisers and will not deal with anybody but the best advisers anywhere in the world is because I want the best noses. I am not really interested in the latest fly-by-night tax scheme. I am interested in knowing what are the legitimate tax costs expected of our businesses and having certainty. Following that rule, yes, we have incorporations in many places around the world, but it has not led us into any pitfalls.”

His colleague Dino Farranoto, head of group taxation for Hutchison Whampoa, adds that: “A lot of the proposals that work on the basis of non-disclosure, which seem to drive a lot of the harmful tax practices that the OECD is worried about, they are not the sort of thing that we would be interested in. I actually welcome the changes because I think that they are making what are considered to be the offshore centres to improve their service levels and the knowledge of their clients.”

Sixt concurs that Hutchison has noticed that the beneficial impact of better supervision is spreading to reputable centres in demands that they know who they are dealing with: “In the overseas jurisdictions where we have dealings, there has generally been continuous improvement in the processes used in

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order to ensure that there is a reasonable level of ‘Know Your Client’. That very fundamental assurance that you are not dealing with money laundering or criminal activity or tax fraud really does come from knowing who you are dealing with. We have seen a significant increase in the level of importance ascribed to that even by the best jurisdictions. It imposes a modest increase on us in compliance and costs but it is a good thing because it helps to sort the wheat from the chaff, making clear which jurisdictions are reputable and which not. It is of course not helpful if a jurisdiction in which we do business is viewed with suspicion by America, Europe or the OECD.”

The Hutchison CFO recoils at the use of the expression “treaty shopping”: “I would never call it treaty shopping. I would call it ordering our affairs. We have decided where to put operations, with a view among other things to have those operations benefit other operations and result in the optimum tax burden for our shareholders. We have a significant presence in Luxembourg, which manages most of our treasury operations, but also holds significant assets. That is very logical. Luxembourg is in Europe, centrally located, well-administered, and does not present any double taxation costs relative to our other European operations.”

As to why Luxembourg was chosen in the first place, he says: “We were significantly expanding in Europe and needed a base from which we would manage significant treasury assets with reasonable access. Canvassing all of the available options at the time in Europe, Luxembourg seemed to offer the best combination of flexibility and efficiency, good infrastructure and being among other things a place where people want to live.

Luxembourg of course is a founding member of what has become the European Union. It is small but an independent country. That is not the case with some of the places that Hutchison has used and where it has no physical plant or operations. One notable example is the Cayman Islands. Sixt has no hesitation giving the Caymans his blue chip stamp. He says: “We have used Caymans Islands companies from time to time to be the issuing vehicle for, for example, US dollar denominated bonds. Essentially this is because those single purpose vehicles (sometimes called special purpose vehicles or SPV) are well recognized in the capital markets and just make it an awful lot easier to raise a bond transaction on the basis of a guarantee coming from the parent company than to structure it otherwise. Colleague Farrauto adds: “The financial institutions know the laws, the prospectuses are pretty much standardised, the lawyers are there. It is just an efficient way of raising money.”

The CFO is quick to underline that there is nothing underhand or hidden about the use of the Caymans: “If you are asking if we have assets stashed away in the Caymans, the answer categorically is no. The other thing that you have to understand is that we have never used any jurisdiction of incorporation in order to create a distinction between what is and what isn’t in our financial statements. So there is no equivalence at all between offshore and ‘off balance’ sheet or between offshore and ‘secret’ or ‘non-disclosed’ – so there is no advantage to us in terms of transparency whether it is the holding of an asset or the incurring of a liability that is through a vehicle that is in Hong Kong or outside of Hong Kong. That must be completely clear. There is a lot of misconception in this area arising out of all of the egregious behaviour in Enron and Parmalat, that offshore is equated to putting things out of sight, hiding liabilities, squirreling assets, diverting assets. That simply isn’t within the realm of comprehension here.”

Sixt, who is an avid reader, quickly adds that there was nothing admirable or even clever in the financial To be a crook you have to want to be – and that is just not part of the culture here.” This of course means tight control. “Of course,” he repeats. “We certainly do that. You would probably be astonished at how tight things like signing authorities are around this group.

“If managers are minded to defraud their shareholders in one way or another, whether that is by concealing liabilities or squirreling assets or overstating revenues or understating costs, there are any of a number of ways that that can be done. The examples are seen going through the courts right now, whether Enron or WorldCom or Parmalat shows. But the starting point is that you have to have to have managers that are crooks.

“The other thing that is fundamentally different here is the fact that Hutchison has a very strong
controlling shareholder [Li Ka-shing, the chairman of the group] who is more interested above anything in making sure that everything that Hutchison is doing is very blue chip and very transparent. I know and everybody in the management team knows with certainty that there will be no reward for us for hiding a liability or squirrelling an asset or overstating the revenue or understating the costs, which is what all of these scandals were in effect all about. Who gained? Certainly not the shareholders: the shareholders were seriously stung. The people who gained were those in a position to enjoy significant appreciation either through stock loans, equity linked compensation, stock options and so on.

“Not surprisingly perhaps, because we have a very strong controlling shareholder, an individual with huge indirect investment in this company, there are no stock options for senior management here. We do have equity-linked compensation in some of our subsidiaries in different marketplaces in order to attract the best talent where that is the market. But it is in our corporate DNA that equity-linked compensation – stock options – is not part of the compensation package here at Hutchison.

“We also have all the structures in terms of internal controls as you would expect in a very large multinational group of this size as well as a large police force, a large internal audit group that works in all 51 of those countries.

“Think of the disciplines required in our retail businesses, handling cash in 6,800 stores in 33 markets. If you don’t have a strong culture of internal controls, it is very easy to conceive of your pocket being picked quietly on the far frontier while you are asleep, and there is no point in doing business that way. So we have a very strong numerate focus within the group, a very strong cash management focus. We effect cash sweeps from all of businesses daily or at the very least weekly basis, largely at the centre. Sometimes at the country level we use major banking intermediaries. But money is not left lying around, nor is the ability to move money around invested into too many hands. In addition to having those structures and cultures, you have to put in place strict and comprehensive internal control policies and then you enforce them on a zero tolerance basis, with a very large police force in internal audit.”

Sixt is modest about the changes he has brought to this regime, claiming: “No one has a mandate to allow our pockets to be picked, and let alone to pick them. All that I have done is constantly review and make sure that the policies and procedures that we have in place are adequate to the task given the rate at which the company has been growing. Plus we have instituted a very significant technological upgrade which allows us to use a very sophisticated level of timely information management to strengthen further the controls. We aim to be state of the art in protection against fraud.”

As to how Hutchison goes about raising funds, Sixt says he keeps a close eye on what the market wants: “Use of a single purpose company is what the market expects. It is a state of the art vehicle, really little to do with us, a normal part of issuing the bond. Once that has been decided, the question is where the single purpose company be. Again the market practice will say it is acceptable in this place and that place, but not acceptable if it is that other place. In terms of our choices, it really boils down to our own comfort level and the relationships with institutions and with professionals. Clearly, there are very good institutions, almost all have a good presence in a place like the Caymans. It has a good historical background as a British crown colony and superb legal and accounting professionals, so it is a place we are comfortable with.

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Sixt adds that the needs of institutional investors in Hutchison paper are important: “Some of it relates to the very complex and various rules that institutional investors themselves are subject to round the world. I am not aware of the detail of what the various institutional investors in various countries can invest if it is a Luxembourg incorporation or a Cayman one or a Hong Kong incorporation, and they can be different. So we just take advice in capital markets transactions as to what is the structure that is going to maximize liquidity.

“Everyone buying paper or shares in public offering brought to us by the biggest and most blue chip commercial and investment banks in the world – people like Goldman, Morgan Stanley, Merrill Lynch, JP
Morgan, ABN, Deutsche and HSBC, all of them talk with us regularly. Everything we do we do in the most blue chip way with the most reputable institutions and the most reputable advisers. That’s critical.”

Changes in technology have played an important role: “Modern technology allows processing of a lot more information in a lot more timely manner. Realistically in terms of the actual working they do make communications a lot easier, turned faster, attachments to e-mails that can be printed out as original documents and signed nicely and couriered back in PDF format. I remember sitting here and hammering out some of the longest telexes on a so-called tested telex. [Sixt came to HK in 1983.] There is no question that there has been a massive enhancement, starting with the fax machine.”

So what advice would he give to a jurisdiction anxious to attract Hutchison? Any place has to lay down a good track record. It is a case of don’t call us, and don’t expect us to call you, but if you do well, we and our advisers will notice. Sixt advises: “Build up the various resources we have discussed and a reasonable track record, and then it has to emerge that in relation to something we are proposing to do, that the logical way to do it is to approach this country. It is not something that we go looking for, but it is something that comes back to us as a market practice. The single purpose vehicle is a good example. There are very simple rules: limit liability, don’t put yourself into a situation where you increase your tax burden by not doing something that you should otherwise be doing.”

The CFO is glad that Hutchison is based in Hong Kong, which he regards as an excellent location for any multinational not least, “because you are not having endless debates with the Hong Kong revenue over non-Hong Kong sourced income. A territorial system of taxation is much easier to manage for a multinational than a residence and domicile basis of taxation because you know right away that the net does not apply to non-Hong Kong sourced income, so that nobody is going to try to make a case that receipts from our retail business in Latvia should be taxed. I remember long ago when I was working in Canada, exhaustive and expressive debates with the Revenue over whether overseas businesses were passive or active in operations overseas and whether as a result they should be taxable or under domestic rules or under foreign rules. Just having the debate is expensive in some jurisdictions. From the point of view of a multinational, having a very bright line between onshore and offshore sources of income and liability to tax is a signal advantage.”
Treaty shopping produces bargains

Leading tax lawyer Milton Grundy (pictured below) summarises some of the new opportunities that the changing international tax landscape offers.

Tax treaties generally provide that a foreign resident without a permanent establishment in the source country pays no source country tax on business profits made in the source country. A well-trodden route has been the use of a Jersey-resident company to do property deals in the United Kingdom. In one recent real-life example, a Portuguese company had property in Portugal to be managed, which an Irish-resident company undertook to provide, and did so by employing various Portuguese contractors. The Irish company was making business profits in Portugal, but was not liable to Portuguese tax, because it had no permanent establishment there. However, the real brains of the Irish company was the owner and managing director of a BVI IBC (international business corporation), and the BVI company agreed to make his services available to the Irish company for a substantial sum, which left the Irish company paying 12.5 percent tax on a relatively small profit. Is there anything special about Ireland in this context? I think the same transaction would work just as well in the United Kingdom, and no doubt in a number of other high-tax countries.

A company involved in a transaction for the purposes of taking advantage of a tax treaty has for many years been called a “Stepping Stone”. In the above examples, the reason the stepping stone pays very little tax is that its profits are diminished by outgoings – a technique called “base erosion”. Another kind of stepping stone does not depend on base erosion. The pattern is essentially similar: the source of income in a high-tax country, the stepping stone enjoys the benefit of a tax treaty with the source country but makes a payment to the zero-tax vehicle; here the reason the stepping stone pays very little tax is not because it deducts the payment it makes to the zero-tax vehicle but because it is located in a country which charges it very little tax. It may seem perverse to say so, but this has in practice been hugely profitable to jurisdictions hosting the stepping stone because it brings income which would never have otherwise gone there. Even if the tax gleaned is not all that significant, it is better than nothing, and the jurisdiction will also have the tax on the profits made by the lawyers and accountants, and by the bank and investment houses, as well as those of the tourist industries.

The whole international tax planning landscape has, of course changed greatly in the last few years. Perhaps the most encouraging aspect is that the European Commission is prepared to tolerate low-tax offshore centres, though not zero-tax.

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been explored. The opportunities – here as elsewhere in the field of treaty-shopping – lie in the anomalies. To take another example: suppose we have a dividend flowing from one EU country to another; suppose the source country is the Netherlands, the stepping stone is a company in Cyprus, and the zero-tax vehicle is a trust in the Cayman Islands. The dividends are paid from the Netherlands to Cyprus gross, under the EU directive. The income of a company in Cyprus is fully liable to tax, but – and here is the anomaly – the “income” of a Cyprus company does not include incoming dividends. Cyprus does not tax outgoing dividends either. So, here is a route by which dividends from a Dutch company reach a zero-tax jurisdiction without a tax charge. It almost seems too good to be true, but I understand that it works in practice, as do the similar – but rather more complicated – routes through Malta or Luxembourg, and all of these are much more tax-effective than the classic route through the Antilles.

One might use this route as part of a structure for a property deal in the United Kingdom. In the absence of a permanent establishment, the Dutch company is exempt from UK tax on its profit under the treaty, and companies in the Netherlands are not subject to tax on profits arising from transactions in foreign real estate. Using the Netherlands for this has some tax “cosmetic” advantage over the use of one of the Crown dependencies: when the UK tax inspector sees a report of a block of flats being sold off by a Jersey company, he sniffs tax avoidance, and wants to know more; when he sees sales by a Dutch company, he turns over the page.

Similar principles apply to a case I know about only at second hand. Here, a Hong Kong company had a contract to build an addition to an oil refinery in Russia. The work was carried out by a Belgian company whose branch in Russia lasted less than a year – so that the company had no “permanent establishment” in Russia and was therefore free of local tax under the tax treaty between Belgium and Russia. It had no Belgian tax liability either, because Belgium does not tax the profits of foreign branches. The dividends then went to Cyprus gross, and under the protection of the EU directive; they were not taxed in Cyprus, and could be paid out gross to Hong Kong. However, Belgium also has a tax treaty with Hong Kong, so the dividend could go direct to Hong Kong, without going through Cyprus. In either case, there would be no tax to pay in Hong Kong because Hong Kong does not tax foreign income.

I should also like to mention two treaty-shopping vehicles of particular interest. One is treaty shopping through life insurance – through, I should more correctly say, life assurance. The short point is that there are two countries whose life assurance companies are well-suited for treaty shopping. They are Ireland and Luxembourg. The assurance company has the benefit of all the tax treaties – including that with the United States, but is not liable to local tax as income and gains accumulated for the benefit of a non-resident policyholder. There may be are other countries that could offer the same tax advantage. What is special about Ireland and Luxembourg is that there are companies there which will invest in the assets the policyholder wants to invest in. Again to take my favourite example, the Hong Kong resident who has the opportunity to take up a 60 percent holding in a new venture in the San Fernando Valley, would effectively avoid the US 30 percent tax on dividends if he were to take out a policy with a life company in Ireland or Luxembourg and the life company made the investment. I understand that this works in practice, though there are arguments that the IRS could use to deny the treaty benefit.

The other vehicle of particular interest is the trust. Of course a trust is not a “vehicle” or anything of the sort. It is a set of obligations owed by a trustee. The American and Canadian tax treaties introduce the fiction that a trust is a “person”, and no doubt we have to construe those treaties accordingly. Other treaties are silent on the subject and there is no helpful judicial authority to point to. But I think the consensus of opinion is that where a person qualifies as a “resident” of country X for treaty purposes by reason of his domicile, residence, place of management etc., and the income or gain actually belongs to him – that is, he is not, for example a nominee or accountable to a tenant for life – then he is entitled to whatever benefit the treaty provides, even though he may be under an obligation to use the money in due course to pay creditors or support charities, or benefit a number of beneficiaries, or accumulate income, or establish a sinking fund, or for that matter to pay trustee fees. Just as a matter of convenient shorthand, I shall refer to such a person as a “trust”.

New Zealand is a good starting point for this topic. A New Zealand trustee of a trust whose settlor is resident elsewhere is not liable to tax on non-New Zealand income received in that capacity, but is never-
Nevertheless a “resident of New Zealand” for treaty purposes. The Australians appear to have rumbled this loophole, but New Zealand’s other treaty partners do not so far appear to be taking any steps to close it. There appear to be some other jurisdictions where a similar anomaly can be located. I am thinking here of Barbados, Cyprus, Ireland and Mauritius, but I should be failing in my patriotic duty if I failed to mention that the United Kingdom is at the top of my list of jurisdictions for treaty shopping through trusts.

The short point here is that a person not resident in the United Kingdom can establish a trust in the United Kingdom which is free of tax on foreign income and free of tax also on capital gains – whether the asset disposed of is in the United Kingdom or elsewhere. The consequences are so astonishing, and so little appreciated, that they are worth drawing attention to. A Hong Kong resident (to use my favourite example), wanting to make an investment in a Spanish company and being advised that when he sells his holding he will be subject to tax on any gain he makes, may prefer to see the investment made instead by a UK trust. The trust may be largely for the benefit of the Hong Kong settlor and his family, but the idea is that the UK treaty with Spain exempts the trust from tax on such capital gain. This is classic treaty shopping, because the benefit of the UK/Spain treaty does not go to a UK taxpayer, but to someone resident in Hong Kong. I can see that if the trust is created for the express purposes of making this investment, the Spanish tax authorities (if they become aware of this, which they may well not) may take the position that this is abusive, but where the trust exists already, there seems to me no basis on which the exemption from tax on the capital gains can be refused.

APPENDIX

Sample trust structure for a Hong Kong pop star

1. Hong Kong pop singer (“Mr H”) settles US copyrights on a UK trustee, on trust to accumulate the income for (say) seven years and subject thereto for a class of beneficiaries consisting of such one or more of a named or defined class of UK-resident individuals and US citizens then living as Mr H (and after his death his widow and after hers his eldest child) may during the seven years appoint, with power to Mr H to vary the class, with trusts for UK-resident individuals in default, provided that UK-residents must receive more than half of the income and capital.

2. A non-UK trustee is added as co-trustee.

Exit

Mr H becomes UK resident, adds himself to the class and appoints an absolute interest in the trust fund to himself. He receives the distribution (including accumulated income) as capital.

OR

Mr H sells his powers to a UK purchaser, who exercises it in his own favour.

Intended Result

The UK trustee is a “resident of the United Kingdom” within Article 4 and a "qualifying person" within Article 23(2)(g), and accordingly entitled to exemption from US tax on the royalties under Article 12.

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