Assessing Offshore

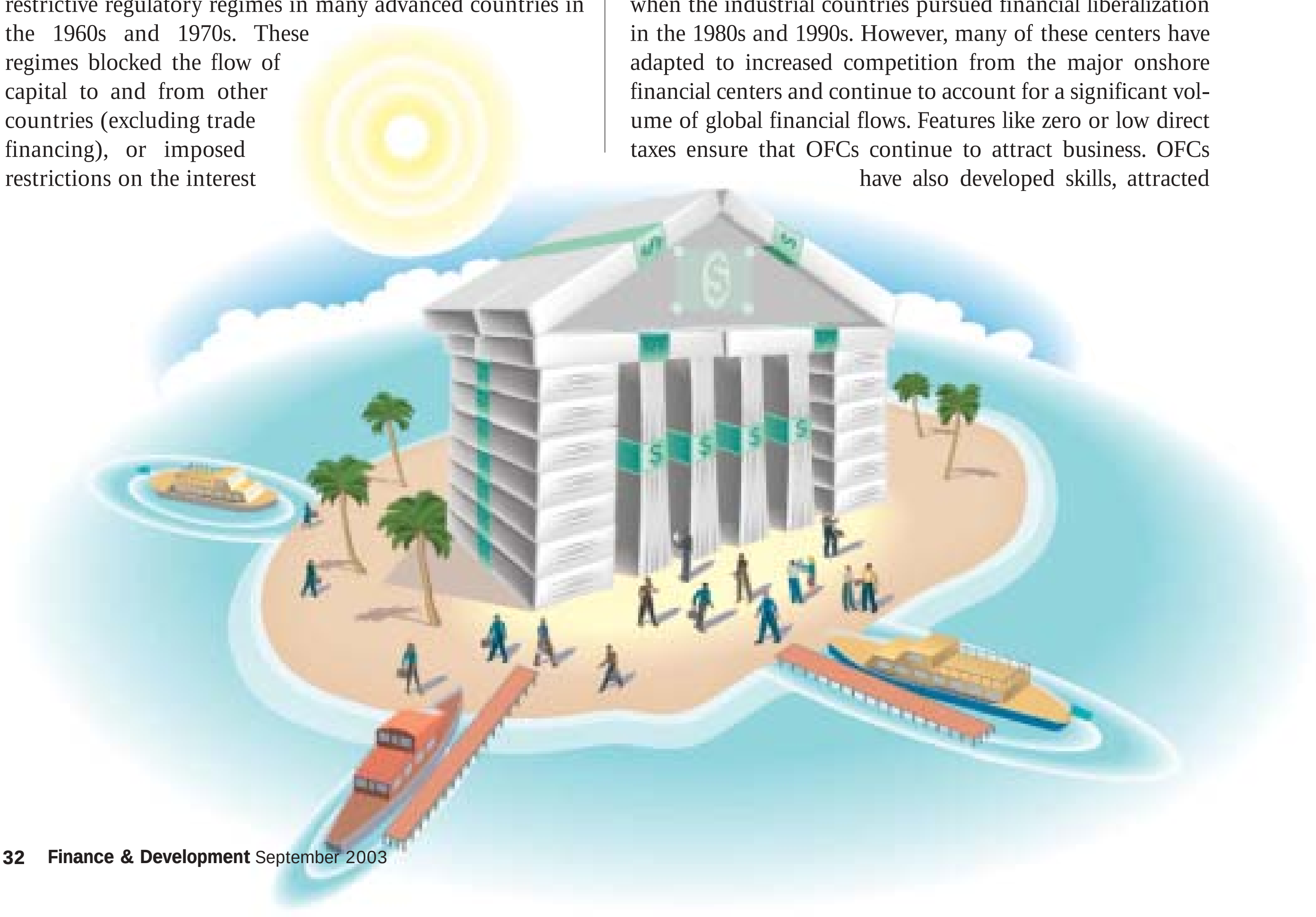
Filling a gap in global surveillance

Salim M. Darbar, R. Barry Johnston, and Mary G. Zephirin

OFFSHORE financial centers (OFCs), despite their name, are not necessarily islands, although many island jurisdictions have established OFCs. Nor is there a single universal definition of an offshore center. One definition of an OFC is a jurisdiction whose financial sector accounts for a significant—and disproportionate—share of its domestic economy. Another is that a majority of financial transactions conducted by institutions located in that jurisdiction are conducted on behalf of clients who reside in other jurisdictions. Historically, OFC jurisdictions have been associated with one or a combination of the following: low or zero taxation; moderate financial regulation and supervision; and secrecy or anonymity in financial dealings. These features, of course, are also found in some onshore jurisdictions.

The growth of offshore centers can be traced back to the restrictive regulatory regimes in many advanced countries in the 1960s and 1970s. These regimes blocked the flow of capital to and from other countries (excluding trade financing), or imposed restrictions on the interest rates banks could offer, or raised banks' funding costs in domestic markets (for example, through the imposition of high non-interest-bearing reserve requirements). These restrictions, which, in many cases, were intended to provide governments with more control over monetary policy, encouraged a shift of deposits and borrowing to less regulated institutions, including banks in jurisdictions not subject to such restrictions. As large multinationals and financial institutions shifted financial activity offshore, the euromarket was established—financial activity, such as taking deposits and extending loans, and dealing in bonds, notes, or commercial paper denominated in a currency other than the currency of the jurisdiction in which the institution is located. These activities, begun in the financial centers of Europe (mostly London), soon spread to other offshore centers.

Some expected that the activities of OFCs would diminish when the industrial countries pursued financial liberalization in the 1980s and 1990s. However, many of these centers have adapted to increased competition from the major onshore financial centers and continue to account for a significant volume of global financial flows. Features like zero or low direct taxes ensure that OFCs continue to attract business. OFCs have also developed skills, attracted



Financial Centers

high-quality professionals and support personnel, and carved out niches by specializing in select financial services or regions (see Box 1). Nevertheless, some smaller OFCs may no longer be viable. To help address potential risks OFCs could pose to international financial stability, in 2000 the IMF initiated a program to assess these centers. The initial assessment program, which is almost complete, has identified both strengths and potential weaknesses.

A source of international concern?

Some of the characteristics of OFCs raise concerns about potential risks to international financial stability. First, since the livelihood of OFCs depends on their ability to attract global financial business, competition is strong. Such competition is beneficial when it contributes to innovation in financial instruments and products and lowers costs of financial services worldwide. However, it can also raise concerns if the lower cost of financial services is achieved by lowering regulatory and supervisory standards. Second, because OFCs provide financial services predominantly to nonresidents, the authorities in the transactors' home countries are interested in the impact on their national economies of the operations in OFCs, especially when these operations are beyond the home country authorities' control. In addition, the lack of reliable data on activities in OFCs hampers analysis, making it difficult to assess the risk that these centers pose to international financial stability.

With the growing integration of financial markets worldwide, problems in a financial institution located in an OFC can be transferred rapidly to markets elsewhere. Consider a parent bank in an onshore jurisdiction with operations (for example, through a subsidiary) in an OFC. If the OFC does not properly regulate and supervise the subsidiary, the latter could take higher risks than might be acceptable to the supervisor in the home country. If a significant part of the bank's total risk is managed offshore, the viability of the whole entity could be jeopardized, with potentially broader risks for the financial system where the bank is domiciled.

The most reliable way to reduce these risks is to ensure good, consolidated supervision of the total operations of the bank by the home supervisor, with adequate regulatory and supervisory standards applied in the OFCs. Effective consolidated supervision requires that home supervisors have access to information on the worldwide operations of the banking group; consolidated supervision is not effective when cross-border cooperation and information exchange with supervisors overseas are weak. Consolidated supervision has become more complex with growing financial conglomeration, as financial institutions are increasingly involved in various

Box 1

Financial activities undertaken in OFCs

Business conducted in OFCs covers a wide range of financial sectors, such as banking, insurance, and securities, and some nonfinancial activities, such as shipping registries. However, most offshore centers specialize in specific types of financial services. Multinational corporations and high-net-worth persons are some of the most frequent users of OFCs.

Banking is the most prevalent business. Most banks located in OFCs are branches or subsidiaries of international banks. Their main activity is collecting deposits from various markets and channeling them back to their parent institutions. Private banking is a major service offered to high-net-worth persons. Specialized services for such clients include asset management, estate planning, foreign exchange trading, and pension arrangements. Some banks also provide nonbank services, such as custodian and trustee services.

Collective investment schemes (mutual funds and hedge funds) are also domiciled in OFCs, mainly for tax purposes. Related fund activities such as allocation of assets, fund distribution, asset management, fund administration, custodian services, and back-office work are also conducted in these centers.

A large number of special purpose vehicles (SPVs), which are increasingly used by financial and nonfinancial corporations, are registered in OFCs. Financial firms use SPVs for securitization, and nonfinancial corporations use them to lower the cost of raising capital. OFCs are attractive places to register SPVs because of the tax advantages they offer, which are supported by a facilitating regulatory regime.

Insurance business—including life, reinsurance (insurance companies that assume all or part of a risk undertaken by other insurance companies), and captive (companies owned by noninsurance firms that provide insurance coverage to the owners)—is also conducted in some OFCs. Innovative regulatory and legal environments have helped offshore centers attract a large share of the world's reinsurance market. A large portion of the world's captive insurance companies (which may do reinsurance) is also domiciled in these centers.

Asset protection, including trusts, is another service offered by OFCs. Reasons for managing assets in OFCs include protection from weak domestic banks or currencies, additional legal protection from lawsuits in the home jurisdictions, and tax avoidance.

The activities described above and others are often undertaken through international business companies (IBCs, or exempt companies) and trust arrangements. In many offshore centers, the costs of setting up IBCs are minimal, and their activities are generally exempt from taxes.

Box 2

Design and scope of assessments

The IMF's OFC assessment program was designed to be a step-by-step process, flexible enough to be adapted to the different requirements of various jurisdictions. Before assessments began, an outreach exercise to explain the program was undertaken in August–September 2000; virtually all OFCs participated. It was envisaged that the program would start with a basic self-assessment followed by a more comprehensive IMF staff–led assessment.

Typically, the IMF would assess the compliance of supervisory and regulatory systems with international standards in the banking sector and in the insurance and securities sectors, if significant, and evaluate the effectiveness of anti–money laundering measures and the regime for combating the financing of terrorism (AML/CFT). Banking supervision was assessed relative to the Basel Core Principles for Effective Banking Supervision, insurance supervision relative to the International Association of Insurance Supervisors Insurance Core Principles, and securities regulation relative to the International Organization of Securities Commissions Objectives and Principles of Securities Regulation.

In April 2001, the IMF Executive Board endorsed the development of a methodology that would enhance the assessment of financial standards relevant to countering money laundering and, subsequently, the financing of terrorism. Since October 2002, the assessments have used the final methodology endorsed by the IMF's Executive Board, which provides a detailed exposition for assessing the implementation of the AML/CFT regime compared with the international standard—the FATF 40+8 recommendations. As the methodology has evolved, assessors in the program have used the most current version.

Besides assessing the observance of supervisory and regulatory standards, some jurisdictions also volunteered for a more comprehensive assessment of the risks to, and vulnerabilities of, the domestic financial system.

aspects of international finance, including banking, securities, and insurance. Cooperation and information exchange are typically much more complicated when several supervisory authorities in different jurisdictions and sectors are involved. Consequently, the supervisory standards applied in OFCs will need to be monitored to ensure that they are adequate.

There is also a risk that market integrity may be compromised by financial crime, such as money laundering. As OFCs are integrated into the global financial system, they become another potential conduit for the proceeds of crime to gain access to, and to be laundered through, global financial markets. Money laundering is an international problem, and, to be effective, international standards against money laundering and terrorist financing need to be applied worldwide, especially in large financial centers. The anonymity of financial transactions, opaqueness of the operations of offshore corporations, and legal protections in some OFCs make them attractive to money launderers. When a financial institution is used for money laundering, its reputation may be damaged. Its business partners may also be tainted. Thus, if a financial center is perceived to be vulnerable to money laundering, investors may avoid it, and its viability may be threatened.

International response

Concerns about the potential risk posed by offshore centers to other financial systems have been raised in several international forums, including the Financial Stability Forum (FSF), the Financial Action Task Force on Money Laundering (FATF), and the Organization for Economic Cooperation and Development (OECD). The April 2000 FSF report on offshore centers highlighted prudential and market integrity concerns stemming from factors in OFCs that impede effective supervision by the onshore home supervisor and hinder cooperation, which is necessary to enhance financial stability and fight financial fraud. In 2000, the FATF undertook an initiative to identify noncooperative countries and territories in the fight against money laundering. The FATF's first review (June 2000) named 15 jurisdictions, including 12 OFCs, as having critical deficiencies in their anti–money laundering systems. Since that review, all but three offshore centers have made significant and rapid progress in addressing deficiencies and have been removed from the list. The OECD has pursued a project on harmful tax practices that affect OFCs, among others. In 2000, it identified 47 countries with potentially harmful preferential tax regimes and listed 35 jurisdictions (mostly OFCs) that met the OECD's tax haven criteria. In 2002, the OECD made public a list of 7 uncooperative tax havens that included 6 OFCs; about 30 other OFCs had made commitments to transparency and effective exchange of information.

The IMF has significantly stepped up its surveillance of financial systems in recent years to identify potential financial vulnerabilities, including those resulting from weaknesses in supervisory and regulatory systems. Traditionally, economic policies of its member countries are monitored by the IMF as part of its surveillance process, and while some OFCs are members, many are nonmembers or dependent territories of members and are thus excluded from IMF surveillance. The IMF's role in OFCs was considered by its Executive Board in 2000 in the context of the IMF's mandate to promote financial stability. At that time, the Board noted that there was limited evidence on the direct risks to the global financial system posed by OFCs. They also noted, however, that when standards for supervision are inadequate and comprehensive risk analysis is hampered by a lack of reliable data on activities in OFCs, there can be risks to financial stability. In response, the IMF designed the OFC program, which has two broad components: financial supervision, comprising assessments (see Box 2) and technical assistance, and statistics.

The response to the program was very positive and the concerned authorities have extended their full cooperation and participation. As a result, 33 of the 44 jurisdictions contacted at the start of the program hosted an IMF-led team of experts by the end of June. The pace of the assessments accelerated from 9 in 2001 to 22 in 2002. A further 11 jurisdictions have hosted, or are expected to host, IMF-led assessment and technical assistance teams in 2003. To date, 12 assessment reports have been published (and are available on the IMF's website), with the consent of the authorities. Most jurisdictions have indicated a willingness to publish their reports, but there is an unavoidable delay between the initiation of an assessment and the finalization of the report because of the internal review process and different stages at which the authorities are given opportunities to comment.

Two distinct groups were identified by the assessments: the larger, more important centers, which have supervisory systems comparable to advanced onshore jurisdictions; and the smaller and poorer jurisdictions, which have significantly weaker supervision. To safeguard their reputations and protect their niche markets, large jurisdictions have focused on supervising cross-border activities important to their centers. Key sectoral findings include

• ***Banking.*** Overall compliance with international supervisory standards was generally appropriate to the nature of the business conducted, especially in the major centers. However, weaknesses were found in on-site and off-site supervision and in supervision of credit, market, and country risk. But since banks in these centers do little retail lending business, the weak supervision of risk was considered less important. Nevertheless, the possibility of banks expanding their loan portfolios suggests that more attention needs to be paid to the supervision of risk in the future.

• ***Insurance.*** Compliance with supervisory standards lagged compared with the banking sector, similar to onshore jurisdictions. The most common deficiencies identified were inadequate on-site inspections and weak supervision of internal controls.

• ***Securities.*** Observance of regulatory principles was generally in line with international standards. The IMF assessed the securities sectors of a much smaller number of jurisdictions (predominantly major centers) because of the relatively small size of this sector in many OFCs. Most weaknesses were related to cooperation with foreign supervisors and information sharing.

• ***Anti–money laundering and combating the financing of terrorism (AML/CFT) regimes.*** Most jurisdictions had some elements of AML/CFT regimes in place, and many were in the process of broadening and strengthening them. Nevertheless, some basic weaknesses in these regimes were identified—for example, the failure to ratify and implement international agreements, inadequate customer identification policies, and failure to ensure adequate anti–money laundering programs in all supervised institutions.

In sum, the areas that need to be strengthened include on-site and off-site supervision, enhancement of information sharing and cooperation within sectors and across borders, increased attention to supervision of the insurance sector, and a broad-based firming up of AML/CFT regimes.

The assessments have underscored the message that there are minimum regulatory standards with which all jurisdictions must comply. During the assessment process, many OFCs upgraded their supervisory and regulatory systems (for example, they enacted new legislation and established financial intelligence units to counter money laundering activities), while others learned how to better supervise their institutions. In some cases, the assessments have made the authorities aware that, while a financial center can be a useful addition to their economy, significant infrastructural investment is needed to provide an internationally accepted minimum supervisory system. Jurisdictions thus need to weigh the costs and benefits of developing offshore centers.

With the growing integration of financial markets worldwide, problems in a financial institution located in an OFC can be transferred rapidly to markets elsewhere.

As part of the OFC program, the IMF has extended technical assistance to a number of offshore centers, helping jurisdictions upgrade their supervisory laws and implement them, close their shell banks (that is, banks licensed in an OFC that are not affiliated with a supervised financial group and whose management resides elsewhere), and develop reform programs. Data on OFCs' international portfolio investments have improved as an increasing number of offshore centers participate in the IMF's Coordinated Portfolio Investment Survey (see *http://www.imf.org/external/np/sta/ pi/cpis.htm*).

Going forward

The initial program has led to improved information about the activities and financial systems of OFCs and is contributing to more transparent supervisory regimes, fostering market discipline and cooperation, and strengthening prudential supervisory systems worldwide. Continued periodic assessments will ensure that well-managed jurisdictions maintain strong supervisory systems and, together with technical assistance, help strengthen the supervisory system of poorly managed centers. ■

Salim M. Darbar is an Economist, R. Barry Johnston is an Assistant Director, and Mary G. Zephirin is a Senior Economist in the IMF's Monetary and Financial Systems Department.