The Significance of IFCs in the Global Financial System

By Professor Gilbert NMO Morris, FSWGC (01/11/2011)

I go immediately to the heart of the matter: International Financial Centres (IFC) are indispensible components in the wheel-works of the global financial system. Principal amongst many advantages they produce and ensure is their efficient, comparatively inexpensive allocation of capital, which, in this epoch of economic decline and financial crisis, has maintained liquidity and value (particularly) in emerging markets, and so restored and maintained the confidence of investors in the world's financial and economic systems.

The global economic collapse and financial crisis of 2007-2008 (and continuing) resulted in the destruction of demand, most notably in America and much of Europe. The governments of the larger Anglo-Saxon nations have treated the economic collapse and financial crisis as a 'liquidity problem'. This is an error. Properly, what we have is a 'balance sheet' problem; which is to say simply: Nothing is worth either what was paid for it or lent against it and the price discovering mechanisms have been largely distorted by formulations of value that offer not even the merest pretence of rigor.

Nodes of Stability

In this vortex of wealth destruction (valued at US$5 trillion dollars thus far), the single exemplar of sustainable demand has been the emerging markets; constituted by China, Brazil, South Korea and India, followed upon by Africa and Russia.

The demand for commodities and services in these countries has given buoyancy to the global economy at a time of collapse and crisis. In such conditions, efficiency in the allocation of capital, speed and certainty of institutional regulations and cost effectiveness in the processing of investment are crucial to servicing and sustaining demand. In the case of the countries aforenamed, in which demand has been sustained, it was international financial centres, specifically Cayman, British Virgin Islands (BVI) and Singapore, leading the way, facilitating and servicing that demand[1]. That has impacted not only the economic and financial viability of the investment culture in the named countries, but the global economy as a whole.

It must be noted that in this facilitation process, select Caribbean financial centres achieved a new level of integration with major financial institutions around the world, and did so in collaboration with well-regulated jurisdictions. For instance, in facilitating investment in China, Cayman and BVI often worked through Singapore and Hong Kong. In most respects, it is not only international banking institutions that speak well of the services and investment structures from Cayman and BVI, it is in fact the regulators in Singapore (and even Australia), who attest to the soundness, credibility and prestige of Caymanian Funds or BVI companies.

For example in May 2011, when Taiwan's Council for Economic Planning and Development announced that the country's first biotechnology venture capital firm -- to be financed by the National Development Fund – would be established in Taipei, the most prominent members of the Fund's board insisted that the company be incorporated in Cayman Islands and threatened to resign unless their demands were acquiesced immediately. *"Johnsee Lee, chairman of the Development Center for Biotechnology and president of the Taiwan Bio Industry Organization, supported the dissenting members' proposal, arguing that the firm would attract more foreign investment if it was based in the Cayman Islands. While acknowledging that several foreign firms earlier chose the Cayman Islands as their operational base to avoid taxes in their home countries, he said the islands had now improved*

their image by introducing procedures to allow easier access to information on firms based there, which have helped them to become a more reputed financial center."[2]

Amongst the many points of relevance thrown up from these facts are the following[3]:

a. Beyond the maintenance of global demand, Cayman Islands and BVI have impacted wealth creation in China, and have aided China in a historic achievement: for the first time in its history, a majority of Chinese people live above the poverty line. This re-constitutes the meaning of economic life in China, even as it impacts the world economically. Specifically, according to the *China Poverty Alleviation Information Network* in 1981, 64 per cent of the population lived below the poverty line. Today, following a decade long intense policy of moving the entire population up the chain of human development, merely 10 per cent of the Chinese population now remain below the poverty line[4]; an effect generated because of investments facilitated by Cayman and BVI structures, which again influenced increased demand from China in the last decade – which, in its turn, motored the global economy.

b. In the same period of the last decade, Brazil has lifted 30 million people out of poverty. Cayman and BVI have had impacts there as well, providing structures, which have facilitated investors who selected them from a market of alternative comparative and competitive options.

c. The US borrows approximately 80 per cent of global savings. The majority of those funds are structured through the Caribbean, facilitating investment in the United States, financing its debt, deficits and household debts and because of this cost-effective facilitation of investment, the Caribbean financial centres have the further effect of sustaining jobs in the United States.

d. The developmental aspects of the Caymanian, BVI and Bermuda[5] successes feed the professional sensibilities of their local financial services experts, whilst providing their governments' access and opportunities to plan, negotiate and operate, generally, at levels beyond where their relative political influence may have taken them.

A financial centre, realised fully, is a composite of coordinated legal structures, supervenient and subvenient global linkages, expertise and capacity that can work as a development mechanism, both within its jurisdictional boundaries[6], and once fully functional, beyond its boundaries because of what it can deliver as a single source.

Moreover, the essential criteria for becoming a financial centre are consistent with good government, the rule of law and fair practices together with an educated labour force. The matter was put thus by the economist Y.C. Jao[7]: Here I reference only a selection of Jao's criteria:

i. Political and social stability

ii. Central and convenient geographical location

iii. Full capital mobility

iv. National treatment of foreign banks

v. A liberal, non-interventionist policy toward business, especially banking and finance

vi. A sound framework for prudential supervision to ensure systematic stability and to protect the legitimate interest of consumers, depositors and investors

vii. A tradition of the "Rule of Law", and a sound, comprehensive system of financial law

viii. A modernised physical infrastructure

ix. A modernised financial infrastructure, and developed financial sector

x. Free flow of information without any restrictions

xi. A business friendly regime

xii. Widespread use of English

xiii. Good quality of life

My emphasis is this: since 1945, the United Nations and its western democratic members in particular have advanced the idea of free democratic government, economic freedom, education and human development. Any jurisdiction intending to become a credible financial centre, will aim in this direction by embodying these principles. Any jurisdiction that is a successful financial centre already does. As such, the proliferation – I emphasise – of credible financial centres advances, implicitly, the goals of prosperity and freedom.

Let me provide an example of how a financial Centre can facilitate the development process: Take Cuba. There you have many development issues for a government trying to find a way to transition to a modern economy. G-20 nations are too large and bring too many corollary constraints to dealing directly with Cuba. However, Cayman Islands is the perfect size and given its experience in financial services, should possess the institutional depth to engage Cuba as a foreign policy proposition, a development partner and a haven for future investment.[8]

That Cayman Islands has English law, western technology systems and reputational capital, together with its financial services expertise, Caymanian professionals are in a position to vouchsafe investments in Cuba by providing intermediation and a comprehensive incorporation and banking centre for companies entering the Cuban space. In support of these initiatives Cayman can also 'slow-walk' Cuban commercial jurisprudence toward western standards by establishing an arbitration centre for Cuban enterprises.

Third, a jurisdiction of Cayman's proximity, unthreatening size, expertise and capacity is more amenable to such an initiative than a large corporation or a larger nation. Cayman has the imprimatur of government and thus, would give additional confidence to investors. Because of its status as a prestigious financial centre, Cayman would be able to cultivate a cluster of bespoke solutions to a variety of problems and has the capacity because of its client base to attain maximum diversification and risk management, bringing a multiplicity of institutions to bear on any development plan, which is in the ambit of no corporation.

Cayman's capacity in this connection was emphasized in the words of Taiwanese officials in the example above: *By opening its headquarters* [in Cayman]*, the Taiwanese venture capital firm would have better access to foreign capital as several foreign firms, unfamiliar with Taiwanese laws and concerned about the continuity of policy in Taiwan, are reluctant to directly channel their funds into the country. Moreover, the Cayman Islands will help the biotech venture seek collaborations with its international counterparts, win international accreditation for its products and allow it to list its shares on international stock exchanges.*[9]

So, for instance, Cayman capacity is because of its status as a financial centre and in our case, given the hurdles to Cuba's internationalization, Cayman can assist Cuba with its currency issues and aid in the development and preparation of a capital market system, developing and enforcing confidence and building corporate governance in order to make Cuba more attractive to investors.

Moreover, in this process, compared to a corporate partner, treaties would provide a framework and platform that is at once more stable and more general than a contract. The net effect of such an enterprise is that with each success, Cayman would gain the confidence of Cuban officials (as they have in Singapore, China and Brazil), putting them in position to advance the cause of reforms[10].

When in 2006, I was charged by the Deputy Premier and Minister of Finance of Turks and Caicos The Hon. Floyd B. Hall, MP (as then he was), to develop the financial centre at Turks and Caicos, it was this model that I sought to build. I began with a plan to link Turks and Caicos with Singapore (in a joint arbitration centre), then with Goldman Sachs and a host of Asian ship concerns to foster the development of a comprehensive shipping and commodities trading platform. The objective was not merely to service external financial services demand, but to do it in such a way as to answer internal development needs, on a tax neutral basis.[11]

There are additional benefits to international financial Centres. Three of the most compelling specific benefits in my view are:

a. Global custody;

b. Commodities trading platforms; and

c. Environmental technology research firms.

Any financial centre thinking of its future will move in the direction of these enterprises. The first offers not only critical skills development but can create a mechanism for short-term investment guarantees, which are critical in the development context. The others respectively triangulate for value the proximity of the financial centre to large population centres and offer an opportunity to leverage investment in the domestic theatre of the jurisdiction.

Additional general benefits of financial centres are:

i. General intermediation

ii. Short-term debt accumulation

iii. Matching lenders and borrowers from third countries (also producer/owner re-insurance)

iv. Measured capital account liberalisation

v. Asset protection

vi. Avoidance of political risk

vii. Immediate impact corporate governance regulations

These things considered reveal that intemperate commentaries about financial centres in recent years have been one-dimensional. The more hysterical writers have claimed that somehow IFCs are centripetal to a nefarious cabal, obsessed with opacity, whose aim or effect has been to distort equaliberal tax obligations by hording cash in places where it cannot be spent.

As such, they have gamely conceded that IFCs are 'at the heart' of the global financial system, merely to emphasise that they are at the centre of global criminality or what *must be* criminality.

Others claim that IFCs are 'parasitic' in the global financial system. But this is self-enveloping nonsense. As the Cayman, BVI, Singapore nexus demonstrates, these jurisdictions are originators of

investment. (The same is true for Bermuda in insurance). That is to say, but for the efficiencies they provide (born of years of expertise), the investments they facilitate could not have been priced for execution, particularly for risk sensitive investors amidst a global economic collapse and financial crisis. Originators of investment cannot be 'parasitic' since the deal terms they offer are based on open-market competition for the most efficient, well-priced models from amongst which they have been chosen.

Less ominous but associated voices have charged that there is a basic unfairness in the existence and operations of IFCs, in that they provide a means for 'aggressive avoidance' of taxation - even though it is legal.

Every major global corporation uses financial centres to develop investment vehicles and to minimise their tax burdens through legal tax avoidance, to allocate capital and to gain the benefits of cost effectiveness.

There is no moral duty to pay a penny more in taxes than the law demands.

Here is the critical point: every nation is right to reform its tax codes by minimising comparative tax rates to attract investment. This is called 'convergence'. In a global financial system, large nations may succeed for a time in abusing small ones, where comparatively, the smaller nation enjoys a natural size advantage where taxes are concerned. Governments are not meant to have an absolute or unlimited power to tax. The falling away of the tax base is a reaction that is meant to discipline governments both to tax fairly and to use tax dollars efficiently.

In Want of the Rule of Law

Invariably, there are companies and individuals who engage in deliberate, illegal tax evasion. And where this is so, such companies and individuals should be put to the question before the law. However, in pursuit of those companies, individuals and even jurisdictions, in order to ensure legitimacy, approaches and enforcement must be fair and proceed according to law. Sadly, no fair-minded person can say the approaches and enforcements – by either the OECD or the G20 - of 'cross-border' financial services regulatory initiatives have proceeded thus.

Since 2007 the G20 – previously an amorphous international talking shop of the world's wealthiest nations – has taken to the status of international Leviathan; demanding and threatening, mostly small nations, to comply with spontaneous promulgations of feckless rules, aimed at defending their tax bases. The G-20 initiatives are a 'third coming', preceded by the *EU Savings Tax Directive*, and before that, The Organisation for Economic Corporation and Development's (OECD), *Harmful Tax Practices initiative*, each selectively imposed on the smaller financial centres - even as the largest crimes emerged from OECD countries, where a criminal lack of regulation in their banking systems lead to the largest economic collapse and global financial crisis in 70 years.

I have addressed the question of illegal tax evasion above. Let me say further that I, myself, am no advocate for tax arbitrage as a business. I surmise that even where it is legal, as a business model, it is mere 'bottom feeding', whilst offering little, if anything in the context of development or opportunities for joint-regulation with respected, private or public sector institutions in other nations.

Having said that, when we examine which jurisdictions engage in pure tax arbitrage, it turns out that this is the preserve of American tax havens, in places such as Delaware, Alaska, Nevada and Colorado. Texas boasts of its 'low tax' luring of businesses, taking companies and so jobs from other states. 'Across the pond' Madonna lived in London – as do other celebrities - because of the lack of competitive tax benefits in her home country. Cruise ships register largely in Miami, because of the comparative benefits to be had there. London has long been the haven in which a parade of African dictators, with grisly habits, have – with impunity – been able to deposit suitcases of cash, with the convenience of good English manners as protection. The same has been the case for slaughter merchants in the Arab world. In the last five years, a 'transatlantic tug-o-war' has broken out between

New York and London, premised primarily on tax arbitrage as the competitive basis for gaining market share in financial services against each other.

Yet, the OECD and now the G20 concentrate their efforts on small, former colonial possessions, and have done so with a disdainful disregard for lawfulness or legitimacy.

As such, in the last 12-years, financial centres – in certain quarters of the world - have become the subject of invective, hysterical selective commentary, super-aided by a mendacious extra-territorial impulse, hedged about with ersatz legalisms masquerading as 'international standards'.

Though things did not begin this way, the origins of these contretemps are founded upon a single word: Tax. However, the history of invective, hysteria and hypocrisy date to the late 17th and early 18th centuries.

This brings the matter round completely: I do not defend financial centres, as such. I regard the composite of a financial centre as a unique and necessary feature in the superstructure of modern finance. However, consistent with the developmental proposition of financial centres, advanced above, I argue for the rule of law. If we are to sustain an international system in which the benefits of prosperity are to be had by the greatest possible number of people, then it is inconceivable that either the OECD or the G-20, neither of which have standing in international law, should act to impose their will on the rest of the world, whilst reserving for themselves the very practices, they raged against in smaller, defenseless, former colonial jurisdictions.

For the most part, we must say that well-regulated financial centres are necessary to ensure fair and efficient global growth. But enforcements attained by threats and selective impositions are not laws, are not "international standards" and are not sustainable.

Under the weight of these onslaughts, the results will not be that financial centres will disappear. Rather it will be that large nations within the G-20, will protect their own financial centres as China sought to do rightly at the G-20 meeting in April of 2009. It will mean that standards of practice will fall, and a new aggressive tax competition will emerge.

The 'success' of the OECD's pogrom, together with the fear, which the G-20 has unleashed amongst mostly Caribbean financial centres, is owing at-large to the accidental origins of financial centres in most cases; but particularly in the Caribbean Basin.

Petite History

Financial services have always been the advance-guard of mainline banking. The Medici – an impressive Florentine banking family of the 14th and 15th centuries - extended their reach through a series of agents and strategic representatives, so to serve their clients by provision of convenient services at distances from the main banking centres. When Mayer Amschel Rothschild sent his sons, one to Naples, another to London, still two others to Paris and Vienna, with one remaining in Germany it gave birth to a new kind of banking service. The transactional nexus between the various banking houses of this family was the essence of financial services - to provide clients with comprehensive access to premium attention for their financial concerns.

The Rothschilds extended themselves further in America in the 19th century through the good offices of JP Morgan; largely an agent extending the Rothschild's service platform in America.

In this limited manner, financial services – as a sub-set of mainline banking – globalised banking services long before the current fetishes of globalisation.

As with all things, finance, race and religion lay at the heart of the matter. Cardinal Richelieu – essentially Prime Minister of France under Louis XIII[12] – sought to purge France of Protestants

(largely Huguenots) even after the Edict of Nantes[13] calling for toleration in 1598. The Protestants fled to Switzerland, but resolved to finance the King of France; such that the first iterations of financial services, beyond the parochial banking cultivated by the Medicis, may be called 'royal banking'. It was during and after the French Revolution in 1789, and between 1789 and 1934 that wealth protection and preservation services were extended to a wider, but discrete population. After 1934, and between 1934 and post World War II, western governments in particular, moved from direct financing of wars, to financing domestic 'social safety nets'.

Increasingly therefore, high taxes became the foil and tax competition became the comparative systemic objective of wealth protection as a rationale for financial services beyond the metropolitan centres of so-called 'high tax countries'.

Conclusion

Whilst Switzerland rose as a financial centre organically, Caribbean financial centres rose by accident and 'spot intuition'. Singapore is really the only financial centre by design (possibly together with Qatar and eventually the Dominican Republic and Russia). I mean by that there was no set of plans, no sustainable home-grown or permanent supplanted or recruited expertise by or upon which the new financial centres came to be established. Taking the Bahamas – for instance – the financial centre arose by means of a single intuition from Sir Stafford Sands, followed upon largely by copy-catting legislation from other jurisdictions, without a comprehensive logistics based on constitutional prerogatives, strategic or competitive realities and relative competence in defending the entire structure according to the prerogatives of competitive advantages, diplomatically.

Moreover, because of their accidental origins, the financial services in most jurisdictions tend to be private sector driven and prophylactic vis-à-vis the political structure; although Bermuda and Cayman Islands have managed this dichotomy with growing skill. This means the requirements of financial centres and the vision of governments are often at cross-purposes. The private sector is often practitioner driven, whilst governments - happy to earn sector generated fees - treats the sector as an imposition; both sides often clueless concerning the ongoing technical foreign policy, legal and strategic expertise required to maintain, defend and advance a credible financial centre in our current epoch. It is upon this that one may draw the conclusion that even 'successful' jurisdictions in the Caribbean Basin are really jurisdictions that offer financial services, rather than financial centres[14], as such.

If the G-20 and its supplementary institutions must adopt the rule of law in a posture of legitimacy, then financial centre jurisdictions cannot wait for this moment. They must cultivate it as an incentive for their survival and as credible members of the international system. In so doing – which is to say by defending themselves according to law – they cease to appear parasitic, and undertake to act as jurisdictions, the basis of whose establishment is the rule of law. By their hands, there must come into being an 'Organisation of International Financial Centres' (OIFC), as evidence of their institutional maturity. They must become knowledgeable concerning the discrete legal basis of a financial centre – beyond merely offering some financial services - and its role in the global financial system, specifically and the international legal system in general; whilst establishing a trade basis for financial services within the context of the GATS[15], determining within such a context when and how to bargain competitive advantages systematically, driven by a spirit of mutual compromise for mutual benefits.

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[1] It should be noted that of the Caribbean Financial Centres only Cayman Islands and Bermuda companies are approved for listing on the Hong Kong Stock Exchange. As such, considerations must be given to the possibility of the approval of US companies – which would require changes to or repeal of Sarbanes-Oxley and some aspects of the USA Patriot Act 2001 - to Cayman's competitive position.

[2] See: China Times, May 12th 2011: Taiwan biotech firm should be based in Cayman Islands: Officials by Pan Yi-Han and Staff Reporters.

[3] In a variety of Articles and papers, Professor Jason Sharman deals with these impacts quite ably. I find I cannot improve upon his commentary.

[4] 2001 – 2010 saw poverty reduction in China move at its most rapid rate.

[5] It is noteworthy that the more successful financial centres are British Overseas Territories or as in the case of Singapore, and Hong Kong, former British colonies; which have managed to become world leaders, not because of British or a recognition of a strategic opportunity to "punch above its weight". But rather they have succeeded in spite of British obfuscation, near-sightedness. Pity. It may have been better had the British looked at the financial centres as potential beneficiaries of its centuries of institutional and administrative expertise, with its Overseas Territories providing it a platform for a foreign policy and global capacity, it can no more – at long last – muster on its own.

[6] As was the case with Singapore, as recounted in *From Third World to First: The Singapore Story* (1965-2000). There Lee Kuan Yew tells the story of Singapore's development of as a financial centre: *"Look here Mr. Van Oenen, we [Singapore] want, within ten years, to be the financial centre of Asia". After indicating that it could b done in five years, Oenen took him to a globe and stated the following, "Look here, the financial world begins in Zurich. Zurich opens at 9 o'clock in the morning, later Frankfurt, later London. In the afternoon Zurich closes, then Frankfurt and London. In the meantime, New York is open. So London hands over the financial money traffic to New York. In the afternoon New York closes; they already handed over to San Francisco. When San Francisco closes in the afternoon, the world is covered with a veil. Nothing happens until next day, 9:00 a.m. Swiss time, then the Swiss banks open. If we put Singapore in between, before San Francisco closes, Singapore would have taken over. And when Singapore closes, it would hand over to Zurich. Then for the first time since creation we will have 24-hour round-the-world service in money and banking"*. (Chapter 5, pp.71).

[7] See: *Shanghai and Hong Kong as International Financial Centers: Historical Perspective and Contemporary Analysis*, by Y.C. Jao. He lists 25 specific criteria.

[8] I could have used Botswana for development in South Africa, or Liberia for development in Central West Africa or Estonia for development in Russia or my favourite: Malta for development in East Africa. Even more than the Cayman/Cuba example above, the Malta/Libya/Egypt potential shows more readily how a financial centre – in this case Malta – can advance both the cause of good governance, financial stability and increased investment.

[9] Ibid.

[10] I have always felt that Haiti's colossal failure is in part due to a lack of vision in the Bahamas, which ought by now to have been in the position to become Haiti's principal development partner.

[11] The objective was to develop a financial centre in the terms described with a baseline of US$100 billion under management, with strategic linkages around the world, around a shipping platform. It never came off. The government suffered quite a menu of local difficulties – many self-inflicted, and was removed by the British. The internal developmental impact of this strategy would have revolutionized the Turks and Caicos, not merely by the introduction of new revenues, but by enhancing its skills mix both in the private and public sectors, it would have forced a rational immigration policy into being (I drafted that section of the immigration bill), and it would have forced local financial services productivity and professionalism on an international service timescale.

[12] The Cardinal was for a time the ally of Louis XIII's mother Maries de Medicis, Queen of France and a descendant of the Medici banking family.

[13] The Edict was revoked by Louis XIV in 1685, leading a mass exodus of Protestants from France to Switzerland, and the near abroad.

[14] Cayman, BVI and Bermuda are examples of 'success'. However, they all lack structural components that would take them into the first tier position as International Financial Centres. Cayman's problem is the greater its successes, the shorter lived they are likely to be for reason which are beyond he scope of this paper.

[15] GATS – General Agreement on Trade in Services. See: Uruguay Round Agreement – ARTICLE I – XXVI. The section is anemic and contains little if anything that may serve as a basis for trade rules in financial services; which amongst other things would be based a theory of "Scalable Convergence" in tax rates, Equilibrium and the Rule of Law.