An assessment of the challenges to Caribbean offshore financial centres

Saint Kitts and Nevis and Antigua and Barbuda

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Introduction

Offshore Shore Centres (OFCs) are generally small, low tax jurisdictions. In defining International Financial Centers (IFC's) the International Monetary Fund (IMF) notes that there must be a large number of financial institutions functioning in a simplified regulatory environment, with low or no tax, and with the majority of its transactions initiated offshore. Regional Financial Centres (RFCs) are groups or blocks of countries, viewed as IFCs and which have specialties in the offshore financial business[1].

Many Caribbean islands, including Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, the British Virgin Islands, the Caymans Islands, the Bahamas, Barbados, and Aruba, can be categorised as RFCs. In the early 2000s, the sector was thriving, and positively contributing to the foreign exchange inflows to these countries.

In the aftermath of the 2008-2009 global financial crises, several regulatory jurisdictions have made attempts to strengthen their financial sector regulation, supervision, and risk management. The objective was to increase the resilience of financial institutions, and prevent another financial sector collapse in the future. Moreover, the regulators sought to restrict potential money laundering and the financing of terrorism, via the implementation of more strict anti-money laundering (AML), countering the financing of terrorism (CFT) and know-your-customer (KYC) regulations.

Post the 2008-2009 financial crisis, several Caribbean countries, including the Bahamas, the Cayman Islands, Saint Kitts and Nevis and Saint Vincent and the Grenadines have been subjected to increased financial regulations by the international financial authorities. This has limited the growth of the offshore financial sector.

This policy brief therefore aims to assess existing and potential threats to the Offshore Financial Sector to selected countries in the Caribbean, with the view of developing recommendations for addressing these challenges. Particular focus is placed on Saint Kitts and Nevis, and Antigua and Barbuda. Interviews were also conducted with stakeholders in other Caribbean countries to assess the wider implications for the subregion.

[1] IMF Staff Discussion Note SDN/16/06.

The study is structured as follows: section one provides a brief historical account of the emergence of the offshore financial sector in the Caribbean, and its importance to the host countries. Section two reviews the international authorities that provide regulation for the financial sector, the financial standards, and the compliance effort of the countries under review. Section three touches on the importance of the Citizen by Investment programmes to Saint Kitts and Nevis, and Antigua and Barbuda. Section four examines the impact of de-risking on the OFCs in the countries under study. Section five offers conclusions and recommendations.

I. The emergence of Caribbean offshore financial centres

The first Caribbean offshore financial centre was established in Bahamas in 1936, by British and Canadian investors. The offshore financial services were eventually integrated as a subsidiary of the National Westminster Bank (Suss et al. 2002). Later in the 1960s, the offshore financial services were expanded to Anguilla, the British Virgin Islands, and the Cayman Islands. The 1980s saw the development of the offshore financial centers in Antigua and Barbuda, St Kitts and Nevis.

The offshore financial centers seemed very attractive to the Caribbean governments, as the OFCs require neither large capital investments, nor a highly skilled and specialized labour force. OFCs commonly provide services which can be grouped in the following categories: a) private investments, which are investments to minimise taxation liability of the client; b) asset protection, which uses international jurisdiction to allow for the protection of the assets of clients from legal risks; c) estate planning, which is the administration of assets in the most favourable legal and fiscal jurisdiction[2]. The following types of financial institutions provide OFCs: commercial banks, insurance companies, mutual funds, and gaming companies.

These early OFCs allowed for employment creation, the earning of taxation revenue for the host government, and the acquisition of foreign exchange. Such positive economic benefits motivated other Caribbean countries, notably the countries of the Eastern Caribbean, to pursue offshore financial centers within their borders.

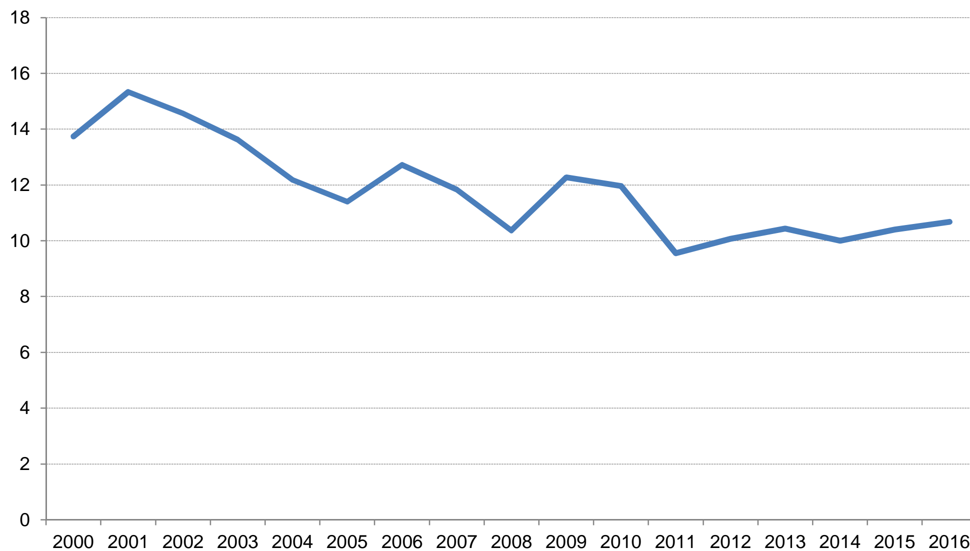
Suss et al. (2002) notes that in the Bahamas and the Cayman Islands, during the initial years of development of OFCs, the multinational firms hired local staff only in lower level positions. Eventually, the multinational firms realised it was more cost effective to train and hire local staff at all levels of operation. Thus, there was a rise in employment generated through OFCs in Caribbean host countries. As the offshore financial services sector grew so too did demand for the upgrading of, various aspects of the local economy such as accommodation (hotels), catering (restaurants), transportation, and infrastructure. This resulted in a positive spillover effect in the host countries.

[2] It is important to note that the proceeds from illegal activities are often processed through OFCs, to conceal the source of funds (Suss et al. 2002).

According to data from the Nevis Financial Services Regulatory Commission (FSRC), the offshore sector accounts for approximately 10 percent of the Gross Domestic Product (GDP) of Saint Kitts and Nevis. This would seem a relatively small contribution when compared to other offshore jurisdictions such as the Cayman Islands, and the Bahamas, where the contribution of OFCs to GDP is estimated at 50 percent and 20 percent respectively. However, the contribution is significant within the St Kitts and Nevis context, as it is the second highest contributor to the economy, following tourism.

The data for Saint Kitts and Nevis as illustrated in **figure 1** show the contribution of the offshore sector to GDP contracting to just over 10 percent by 2016, from around 15 percent in 2001.

Figure 1
Nevis percentage contribution of offshore sector to GDP
(Per cent of Nevis total current revenue)



Source: Generated by authors; data from FSRC.

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II. International standards for International Financial Centres (IFCs)

There are three main global bodies setting standards for International Financial Centers (IFCs). They include: the Organisation for Economic Cooperation and Development (OECD), the Financial Action Task Force (FATF) and the International Monetary Fund (IMF).

The OECD's mission is to promote policies which would create economic and social improvements for people globally. The OECD provides a forum for governments to work together and share information for the betterment of global issues under their purview. Small island territories lack both the financial resources and political weight of the more developed countries, characteristics for membership to the OECD[3]. In 2014, forty-seven countries tentatively agreed on a "common reporting standard" (CRS) for the automatic exchange of tax and financial information on a global level[4]. Currently, the CRS is an automatic standard for the reporting of tax and financial information. The premise is that non-reciprocity agreements in the area of financial information exchange create a climate for tax havens.

The massive financial flows, and growth occurring in the sector, attracted the attention of the Financial Stability Forum (FSF) and the Financial Action Task Force (FATF) (Tranoy 2002). Several measures were introduced by the FSF and the FATF for combating money-laundering, and countering the financing of terrorism. Not surprisingly therefore, interviews with stakeholders5 in the financial sector in Saint Kitts and Nevis, and Antigua and Barbuda revealed that financial regulators and industry practitioners are reluctant to accept clients with limited disclosures, or with some perceived

[3] The OECD governing body, which is comprised of all the members, decides whether to open accession discussions with a country. The governing body also decides the terms, conditions and process for accession. The terms, conditions and process for the accession are typically set out as roadmaps for each country (OECD 2017b).

[4] The 47 countries were comprised of 34 OECD countries, as well as Argentina, Brazil, China, Colombia, Costa Rica, India, Indonesia, Latvia, Lithuania, Malaysia, Saudi Arabia, Singapore, and South Africa (OECD 2014).

[5] Questionnaires were administered, and interviews were conducted with senior officials from the banking, and non-banking financial institutions in Saint Kitts and Nevis, and Antigua and Barbuda. A total of x persons were interviewed over the March 2017, to August 2017 period, from x banks, and x non-banking institutions. There was also, x percent non-response error.

reputational risk. Stakeholders interviewed also noted there has been continuous implementation of measures toward complete CRS compliance. Additionally, there have multiple bilateral treaties for exchange of financial information with major trading partners.

The Financial Action Task Force has responsibility for setting standards for combating money laundering, and the preventing the financing of terrorism. The Caribbean Financial Action Task Force (CFATF) falls under the purview of the Financial Action Task Force and comprises twenty five (25) countries of the Caribbean basin. The CFATF main objective is also to achieve compliance with the Financial Action Task Force, and prevent money laundering, and combat the financing of terrorism.

The IMF's role in monitoring International Financial Centers is to conduct periodic reviews of financial centres, with a view to measuring compliance to international regulatory standards as set by standards-making bodies like Basel Committee on Bank Supervision (BCBS), International Organisation of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS).

In addition to these regulatory and monitoring bodies, Caribbean IFCs are also faced with ongoing rules and standards by individual developed countries like the United States FATCA and the United Kingdom's CDOT and Public Registry of Beneficial Ownership (PRBO). The CDOT and PRBO specifically apply to ten Caribbean Crown dependents and territories. These two initiatives also impact compliance operating models differently and may lead to additional costs and resource burdens on these jurisdictions. Further, they create the added challenge of multiple reporting and managing interactions with many governments.

In 2010, the United States Congress passed the Foreign Account Tax Compliance Act (FATCA), requiring non-US financial institutions and certain non-financial foreign entities to report on the assets held by their U.S. account holders, or are subject to withholding on withholdable payments (IRS 2017). Financial institutions, both onshore and offshore note that the implementation of the FATCA legislation has been burdensome and costly, and the continued monitoring for clients or potential clients with "U.S. ties", is time-consuming and expensive. What is central here, is the fact that the relevant institutions in the Saint Kitts and Nevis, and Antigua and Barbuda have implemented FATCA, and are in the process of facilitating their reporting.

Apart from the standards introduced by the US, and the main regulatory bodies, in 2016, the United Kingdom has introduced the Public Registry of Beneficial Ownership (PRBO), (Open Ownership and Global Witness 217). The Public Registry of Beneficial Ownership was designed with the objective of creating transparency of beneficial owners of business and property of U.K. citizens. Interviews with stakeholders note that the cost of compliance with the Public Registry of Beneficial Ownership puts them at a disadvantage, as this is not a global requirement.

With specific reference to the region's efforts at compliance, in terms of monitoring, the Eastern Caribbean Currency Union (ECCU) economies have several levels of supervisory oversight for assessing AML and CFT practices. The Eastern Caribbean Central Bank (ECCB) is responsible for direct prudential oversight of domestic banks in the Eastern Caribbean, while the Financial Services Regulatory Commission (FSRC) has the responsibility for AML and CFT monitoring.

The financial sector legislation of both Antigua and Barbuda and Saint Kitts and Nevis is closely modelled on international standards and legislation of the more developed countries. In Antigua and Barbuda, the Money Laundering (Prevention) Act was implemented in 1996, while Saint Kitts and Nevis gave assent to its Anti Money Laundering Act in 2011. The legislative framework for both islands applies to international banks and company registration, establishment of trust, international insurance companies, money services, credit unions and provisions of the citizenship by investment programme. It also includes on-site examination of these regulated entities.

In terms of the current legislative agenda, banks in Saint Kitts and Nevis have implemented Foreign Account Tax Compliance Act, and begun the implementation of the Common Reporting Standard. They have committed to the implementation of most of the elements of the CRS, including

the primary and secondary legislation by 2018, as well as to the List of Non-reporting Financial Institutions and excluded accounts. Antigua and Barbuda is FATCA ready and has committed under the OECD to implement both the primary and secondary CRS legislation by 2018.

Moreover, some financial institutions in both islands have also adopted the Risk-Based Supervisory Framework, which includes a combination of internal and external audits, an approach recommended by regulators.

Many of the stakeholders interviewed noted that they were sometimes over-regulated, a practice which they note, has negatively impacted their competitiveness. For example, the Beneficial Ownership Act of Antigua and Barbuda, requires the publication of share-owners, beyond the majority share-holder. The interviewed stakeholders expressed the view that the law went beyond the minimum requirement. Moreover, they were unsure how the process should work, as no consultations were held with the financial sector prior to the approval and implementation of the law, yet steep fees for non-compliance have been implemented.

At the micro-level, due diligence processes of both Saint Kitts and Nevis, and Antigua and Barbuda appear to be satisfactory. For one to open a bank account two valid pieces of picture identification are required, as well as proof of address and income or retirement, a practice that more or less exists throughout the Eastern Caribbean and wider Caribbean Community (CARICOM). In some more developed jurisdictions the process is simpler. In the U.S. for example a single piece of identification and a social security number is required for the opening of a bank account.

The problem in the countries of interest does not appear to be limited legislation or inadequate supervisory regimes, but transparency, based on the measures of the global rule-making bodies and developed nations, and proving compliance in a global system where compliance appears to be measured by enforcement numbers. IMF (2017) report on the ECCU note that the cost of securing new correspondent banking relationships can be reduced through stronger anti-money laundering and counter financing of terrorism legislation and supervision, bank consolidation and improved communication. The IMF (2017) study did note improvements in the quality of statistics and data collection in the ECCU region, but also identified the need for further progress and enhancement in the quality of surveillance and policy analysis.

III. Citizenship by investment programme

The Citizenship by Investment (CBI) programme has been widely used as a fiscal tool by some CARICOM member states. The programme dates back to 1984 for Saint Kitts and Nevis, and was established in 2014 in Antigua and Barbuda. Both countries reviewed appear to have a very strong reliance on the CBI programme for financing their recurrent expenses. Destabilisation of this programme therefore, could have significant negative consequences for overall fiscal management.

The OECD has in the past categorized CBI programmes as vehicles for tax avoidance. Public officials interviewed for this study advocated the integrity of the due diligence process, and outlined a rigorous, multi-layered vetting approach; with failures in due diligence at a minimum. The programme however appears to have played a role in increasing the countries' reputational risks, and these reputational risks may have contributed to the eventual loss of correspondent banking relationships.

Some well-established domestic commercial banks in the countries reviewed curtailed the acceptance of CBI funds since 2016. In Antigua and Barbuda, a leading bank terminated its CBI banking ties, while in Saint Kitts and Nevis another market leader in commercial banking also dropped that business from its portfolio.

It may be necessary for regional governments to go a step further in promoting the transparency of the CBI programme, and by establishing a public registry of approvals. Increased exchange of information treaties with countries may also be useful in the financial background due diligence checks of applicants.

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IV. The impact of de-risking

In considering the impact of changing regulation on Caribbean economies, and by extension the operations of OFCs, while the IMF (see table 1) asseses the impact of loss of correspondent banking relations (CBRs)[6] on Saint Kitts and Nevis as negligible or moderate, interviewed stakeholders noted that while National Bank in Saint Kitts still maintained intermediary services, the de-risking of Bank of Nevis has significantly impacted business, given that more than 90 percent of offshore transactions are in U.S. dollars. Industry participants also pointed to a 300 percent increase in wire transfer fees from USD100 to USD300. One interviewed financial sector practitioner noted that compliance costs also increased by approximately 30 percent, while profit margins have suffered.

Moreover, some bankers noted an indirect, but critical drawback of de-risking as the weakening of the ability to monitor anti-money laundering, and counter financing of terrorism activities that the digital footprint of cross-border wire services provides. Clients have been forced to use alternative measures for making payments that are not as easily tracked. This may be the most dangerous impact of de-risking- the inadvertent creation of an underground market for USD. There appears to be a return to traditional methods of moving money via cash. This not only undermines the ability of financial institutions to track transactions, but it also limits opportunities to block suspicious transactions through an electronic clearing system. The impact to these countries may therefore be more severe because of the broad and lingering implications.

[6] In correspondent banking, a respondent domestic bank forms an agreement with a correspondent international bank to execute payments on behalf of the respondent bank and its customers. Correspondent banking relationships (CBRs) with international banks are important for domestic banks as it allows the domestic banks to access the international payments system. The *"De-risking is an umbrella term used to describe strategies adopted by global banks to lower the overall risk exposure of their asset portfolio in response to tighter regulatory standards imposed by national and international regulatory."* (CCMF 2016, 4). As such de-risking is essentially the reduction of business relationships with domestic "respondent" banks by international "correspondent" banks. It includes, the termination of correspondent banking relationships (CBRs) with local banks; the withdrawal from selected markets; and the closing the accounts of selected clients and classes of clients.

Table 1
Impact of the withdrawal of correspondent banking relationships

No significant impact/moderate impact	The Bahamas, Barbados, Costa Rica, Cyprus, Grenada, Guatemala, Saint Lucia, Tonga, El Salvador, Guyana, Jamaica, Kiribati, Kuwait, Lebanon, Morocco, Panama, Samoa, Saudi Arabia, Solomon Islands, Sri Lanka, Saint Kitts and Nevis, Saint Vincent and the Grenadines, and the United Arab Emirates.
Adverse impact	Belize, Iran, Liberia, and Sudan.
The quantification of the loss of business in respondent banks	
The Bahamas	Six institutions, representing a small share of total about 19 percent of banking system assets, have recently lost CBRs.
Belize	Only 2 of the 10 domestic and international banks have CBRs with full banking services. The Central Bank of Belize lost three CBRs.
Liberia	All commercial banks have lost at least one CBR in the last 3 years, with the most affected losing about 78 percent of their CBR accounts (SIP).
Panama	The total number of CBRs remained stable at 463–464 between March 2015 and End-February 2016 (62 relationships were lost, but Panamanian banks managed to establish 63 new relationships).
Sudan	Sudan lost almost half of its CBRs between 2012 and 2015.

Source: IMF 2016-Recent Trends in Correspondent Banking Relationships.

V. Recommendations

With the on-going challenges to the offshore sector, there is clear need for a policy shift in the region towards greater transparency and strengthening functional cooperation as well as policy coordination. Such an approach would go a long way in allowing the Caribbean offshore financial sector to successfully respond to exogenous shocks.

There is need for greater regional coordination when addressing issues which impact Caribbean economies in general and the offshore sector in particular. Such coordination should embrace the private sector. A good example is the approach adopted by British Virgin Islands, where the private sector is actively engaged with the government in the policy formulation. Allowing the regional private sector to have a supporting role could be a critical tool in helping to shape the codes and rules and in communicating the challenges which small-island developing countries face in the OFC sector.

There appears to be a mismatch between the expectations of the private sector and policy positions of regulators, which speaks to the need for a public-private sector consultative process which informs domestic and regional policy-setting in respect of the offshore financial services sector. The private sector noted the critical need for structured consultative processes to ensure that all threats and market fallouts are assessed from both the regulatory and policy standpoint, and with some assessment of the market impact.

Unlike other jurisdictions, CARICOM member states appear to have individual approaches to regional threats. Market practitioners referenced the BVI model of public-private sector consultative process as one to be emulated in achieving legislative compliance and in addressing the growing challenges to the offshore sector.

A significant challenge to member states is the limited availability of published economic data relating to the regional offshore financial sector. There is little or no data collection or tracking of statistics in the countries of interest. Hence, it is recommended that a proper system for data/statistic collection be implemented, and undertaken in partnership with the private sector. The recently endorsed CARICOM Action Plan on Statistics, led by the Honourable Keith Mitchell, Minister of Grenada, could be a key vehicle for the accomplishment of this goal.

The regulatory frameworks which govern banking and offshore financial services are consistently changing to address potential and emerging threats to the sector, and to ensure the highest levels of transparency. The regional offshore sector needs to be cognizant of and responsive to

changes in the regulatory frameworks, which in many instances threaten the economic stability of these member states which are highly dependent upon the offshore financial sector. Some of the more vocal regional advocates have categorized these threats as unfair; noting that the small size and portfolio of regional offshore banks and trusts present a significantly smaller probability of anti-money laundering and counter the financing of terrorism contraventions than many larger, global financial institutions.

Moreover, there is little accommodation for either size or capacity in the application of global rules and in meeting compliance deadlines. This places tremendous pressure on the resources of small islands to meet compliance deadlines, a situation that makes them more susceptible to being negatively listed.

In moving forward therefore, the international community should be mindful of the economic importance of the offshore financial sector to many Caribbean countries. As such, the efforts of both global and national standards setting agencies should be guided by the need for a levelling of the playing field as it were. The challenges to the sector present an opportunity for the Caribbean policy makers to defend the gains of an important sector which is linked to the diversification of services in the region.

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