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Introduction

1.1 Rationale for the study

The project *Considering the Consequences: the Developmental Implications of Initiatives on Taxation, Anti-money Laundering and Combating the Financing of Terrorism* assesses the costs and benefits of implementing new international regulations for small Commonwealth states with significant international financial services (IFS) sectors. The goal is to improve policy and operational outcomes by: (a) systematically assessing the impact of recent financial regulatory standards and reforms; and (b) providing this information to local stakeholders and governments, as well as multilateral organisations involved in improving the stability and quality of the international financial regime.

The project is important because IFS sectors provide an important source of external revenue and economic development for a large number of small Commonwealth member states that lack obvious alternative development options. Many such states were actively encouraged by donors and international financial institutions (IFIs), as well as by global accounting and law firms headquartered in Organisation for Economic Co-operation (OECD) countries, to set up international financial centres (IFCs) as a means of increasing their export income from high-value service exports. In combination, recent multilateral regulatory initiatives have often been see by IFCs as posing a threat to the viability of their IFS industries in particular, and to their economies in general.

Yet, until this project, no attempt had been made to study the overall impact of changes that have occurred in regulatory standards and practices, nor of their specific effects in IFCs. The project seeks to correct this lacuna by undertaking the equivalent of what is referred to in OECD member states as a regulatory impact assessment (RIA) in three small Commonwealth IFCs.

To address at the outset a key concern expressed by the agency that funded the study (FIRST) and its sponsors, it bears emphasising that the project is not aimed (implicitly or explicitly) at criticising or undermining new international regulatory standards. The project takes the new standards that have been put in place as a given. Its focus is, instead, to make an overdue *empirical* assessment of their costs and benefits. On the other side of the coin, to address a different, but even more strongly expressed, concern on the part of many small jurisdictions, the project was not intended or designed to convince small states to exit the market for IFS.

The project as a regulatory impact assessment

The cost-benefit assessment attempted under the project in the three countries concerned is similar to a regulatory impact assessment (RIA) of the kind undertaken in many OECD countries. An RIA is a systematic assessment of the costs and benefits resulting from government regulation. Such an exercise can either be conducted *ex ante* to determine the possible costs and benefits of a number of potential regulatory solutions to a given policy problem, or, as with this project, *ex post* to discover the costs and benefits of already existing regulation and communicate these to policy-makers for them to examine whether course-corrections might be in order. Such *ex post* policy monitoring can lead to revisions to existing policies to improve their effectiveness and efficiency, and to ensure that regulation achieves its intended aim rather than generating unintended and undesirable consequences.

Assessing the wider impact of regulation – i.e. beyond its direct cost to government – is a goal strongly endorsed by the OECD, World Bank and other multilateral bodies as constituting best international practice. In a majority of OECD member states, RIAs are routinely used, if not legally mandated, for all new regulatory proposals before policies are enacted. Moreover, periodic *ex post* reviews are conducted in almost all OECD countries to examine whether the regulation that has been put in place (in terms of laws, rules and so on as well as the practices and behaviour of regulators) is achieving the purposes for which it was intended, or whether it is resulting in unnecessary costs and unintended consequences. The uptake of the RIA has been slower in developing countries. However, there is a similar trend towards seeking a broader understanding of the impact of regulation both *ex ante* and *ex post*, including the indirect economic, social and environmental costs of compliance.

The information gathered in an RIA can be useful in promoting accountability and transparency in line with the overall priority of ‘good governance’. It can achieve these goals by encouraging feedback from firms and individual citizens on the effects of regulation, and make clear the magnitude and distribution of costs and benefits produced.

Assessing the costs and benefits in the current project is particularly important given the prominent role outside multilateral institutions have had in designing the current financial standards and procedures in place in each of the three countries. Because such institutions do not have direct links with those affected by the regulatory standards they propagate, studies such as this are especially important in promoting transparency and accountability. These circumstances also put a premium on findings and local feedback reaching multilateral standard-setting bodies so as to facilitate policy improvements.

Relevant multilateral regulatory initiatives

The project was commissioned to examine the impact of new regulations affecting the IFS sector in small Commonwealth states with particular reference to the Organisation

for Economic Co-operation and Development's (OECD) Harmful Tax Practices initiative in the area of international tax information exchange, and the activities of the Financial Action Task Force (FATF) relating to anti-money laundering/countering financing of terrorism (AML/CFT).

There is a large degree of overlap in the requirements of the OECD for international tax information exchange and the FATF's standards in relation to AML/CFT. At most basic, both require that public and private entities collect more information on the consumers of financial services than they did before and are more willing to share this information internationally.

Indeed this overlap goes deeper in that organisations such as the International Monetary Fund (IMF), Bank of International Settlements (BIS), Financial Stability Forum (FSF) and others have either designed, replicated or endorsed similar regulations. Thus, for example, the requirement for offshore banks to have 'mind and management' in-country was originally specified by the BIS, before being endorsed by the FATF and the OECD, with the monitoring of compliance with this requirement being jointly the responsibility of the IMF.

This report and each of the country studies gives much more attention to the FATF and AML/CFT regulations than to issues of international tax information exchange. In part this reflects the concrete measures undertaken with respect to AML/CFT compared with the commitments made, but not yet implemented, in relation to the exchange of tax information. However, it is important to stress that the specific FATF regulations that have had an important impact (such as 'know your customer/due diligence' (KYC/DD) requirements) are also key elements of the OECD initiative.

1.2 Design and methodology of the study

The project was originally intended to include seven countries. However, in order to fit a reduced budget, keep the report to a more manageable size and ensure early results, this intention was subsequently reduced to three countries. In selecting the three countries assessed, several factors were taken into account. To ensure that the project's results were valid and broadly comparable, it was decided to cover IFCs in three island regions: the Pacific and Indian Oceans and the Caribbean Basin. As the project was undertaken under the umbrella of the Commonwealth Secretariat, the countries had to be Commonwealth members. There was also a strong presumption that they should also be eligible for FIRST funding[1]. This condition restricted the project's focus to sovereign states. For that reason it excluded United Kingdom Overseas Territories or Crown Dependencies such as the Cayman Islands, Jersey, Bermuda etc. Within these constraints, it was decided to focus on larger, more established IFCs in each region.

In Africa and the Indian Ocean the field was narrowed to Mauritius and the Seychelles. Botswana was discussed as a possible substitute if political approval from either of the two Indian Ocean nations was not forthcoming, though this fallback proved unnecessary. Mauritius was selected because of its larger financial centre.

In the Pacific there are three Commonwealth IFCs: Samoa, Vanuatu and the Cook Islands. Once again, Vanuatu was selected because it is a more established IFC (being set up in the early 1970s), and because IFS are a larger component of the economy. Moreover, as the Cook Islands are in free association with New Zealand rather than a sovereign state, it was not eligible for FIRST funding.

The Caribbean region offered a wider range of independent Commonwealth IFCs, including Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, St Kitts and Nevis, St Lucia, and St Vincent and the Grenadines. With only a limited subset of this sample being eligible for FIRST funding, Belize and St Vincent and the Grenadines were initially selected. Although not on the FIRST list, Barbados was included in the study later with the permission of FIRST, as it was felt necessary to instead include a Caribbean country whose IFS sector was more significant in size and well-established than either of the other two states.

These decisions should not be taken as suggesting that a similar project including such IFCs as Samoa, the Seychelles or Eastern Caribbean states would not produce equally valuable results. On the contrary, the authors believe that both the countries concerned and multilateral standard-setting institutions would derive considerable benefit from a fuller picture generated by similar studies covering all the smaller Commonwealth and non-Commonwealth jurisdictions.

The three Commonwealth IFCs chosen – while large in comparison with many other Commonwealth IFCs – are not of the same size as the Channel or Cayman Islands or Bermuda. Yet the three 'mid-size' IFCs chosen do represent a broadly representative sample of the characteristics of most Commonwealth IFCs. For that reason, it can be asserted with a degree of confidence that the findings of the project (distilled in this report) would probably apply with equal force to other Commonwealth IFCs without any significant exceptions, though once again the report endorses the need for further research to confirm this hypothesis.

Questionnaire design

In assessing the impact of new financial and tax regulation, the project aimed to take into account as wide a range of costs and benefits as possible. This breadth was in keeping with the RIA rationale of measuring the total impact of regulation insofar as that was possible. Thus, early on the in the project, it was decided to include banks, corporate service providers (CSPs), insurance and asset management companies, accounting firms, securities firms, auditors, law firms, regulators, ministries of finance, central banks and financial intelligence units. There is therefore comprehensive coverage of the public and private financial sector players that are involved in providing IFS in Barbados and Vanuatu, although in Mauritius a local decision was taken to exclude all operators other than management companies (MCs) and banks providing offshore banking services.

Each of the relevant multilateral organisations has issued guidance as to how countries are to comply with general standards on tax information exchange and AML/CFT. For

the FATF these are the 40+9 Recommendations[2], which have been bolstered with extensive guidance and interpretive notes compiled in co-operation with the IMF and the World Bank, and have been refined in an ongoing programme of peer assessment among the regional AML bodies. For the OECD, these are the similar guidelines drawn up by the Joint Ad Hoc Group on Accounts and the Global Forum on Taxation.

For the purposes of this study, **costs** were disaggregated into human resources, office space, training, IT systems comprising software and hardware, risk procedures, legislative design, internal audit, external audit and compliance procedures. Measuring and quantifying **benefits**, in particular, posed particular methodological challenges. These were separately identified in the questionnaire as including increases in competitiveness, volume of business, fees and levies, productivity as well as more specific AML/CFT-related variables.

It proved easier to measure the costs of new regulations associated with multilateral initiatives than to quantify benefits. The benefit to jurisdictions and firms was primarily that of preserving or enhancing reputation, and thus difficult (if not impossible) to quantify except perhaps in an indicative or illustrative sense. Nevertheless, it was important to get at least an approximate idea of benefits to ensure a balanced study and to come to an assessment of the net effect of the new regulations. Note that although the last section in the questionnaires covers benefits, it was possible for respondents to register 'negative benefits' quantitatively, e.g. a decline in business or profits in certain years as a result of regulatory initiatives.

Separate versions of the questionnaire were designed for the public and private sectors. In each case it proved necessary to strike a balance between sufficient detail to provide for a comprehensive RIA, but also sufficient 'user-friendliness' so as not to over-burden respondents and depress response rates. This latter concern was particularly pertinent in an atmosphere of 'initiative and survey fatigue' in all three jurisdictions, where demanding reporting and compliance requirements from the OECD (the Template for the Harmful Tax Practices initiative) and the IMF (the Offshore Audit) have already taken a great deal of participant time and energy. To add to these burdens, the Financial Intelligence Unit (FIU) in Mauritius decided to launch its own 'counter-survey' at the same time the study was being undertaken in that country. Fortunately, judging by the very encouraging response rate (higher than in Barbados or Vanuatu), this did not seem to affect the number of those willing to complete the survey. A qualitative version of the questionnaire for the private sector was also drawn up for those firms unable to answer the full quantitative version.

The response rate for the qualitative questionnaire was very high, on average at least 90 per cent, but the response rate to the quantitative survey was much lower, as the private sectors in Barbados and Vanuatu and the public sector in Barbados in particular were unable/unwilling to provide the detailed statistical material requested.

In designing the layout of the questionnaire, the first step was to look at the requirements of the two most important regulatory initiatives affecting the three states in question: the OECD Harmful Tax Practices initiative (formerly know as the Harmful

Tax Competition initiative) and the Financial Action Task Force's (FATF) efforts to improve AML/CFT standards.

In light of the confusion over reputational effects (see below), some members of the IFS industry pointed out that questions on reputation might more profitably have been directed at foreign consumers of the IFCs' services; however, budget and time constraints prevented modification of the questionnaire design and administration along these lines.

Regional workshops

Regional workshops were held in Vanuatu (10 March 2006), Mauritius (10–11 April 2006) and Barbados (21 April 2006) and comprised a vital part of the overall project. The aim in each case was to preview the results drawn from the earlier interviews and surveys, to refine the accuracy of the preliminary findings and to ensure the final conclusions of each country report faithfully reflected local opinions. The workshops also enabled lead and local consultants to clarify those points on which survey data had provided only vague or contradictory results.

The workshops were organised as half-day (Barbados), full-day (Vanuatu) or three half-day (Mauritius) events. Invitees were drawn from public sector regulators and the IFS sector. The authors would particularly like to express their gratitude to the Central Bank of Barbados and the Bank of Mauritius for generously agreeing to co-host these events in their respective countries. Their hospitality and the efficiency of their staff in organising these events were most impressive.

Although the organisation of each workshop differed in line with local circumstances, each featured a brief summary of the preliminary results, set-piece responses from prominent representatives from both the private sector and local regulatory bodies in the IFS sector, and more general discussion. In each case the feedback generated was invaluable in sharpening the conclusions of the country studies, and in informing this report.

1.3 Structure of this report

The remainder of this report is structured as follows. Chapters 2 to 5 comprise an introduction to and regulation of the international business and financial services sector in Barbados, overall findings from the case study questionnaires, interviews and workshop, and conclusions for that country.

The Mauritius case study is considered in chapters 6 to 9, which includes development of the IFS industry in that country, the importance of the industry and its regulation and supervision. Chapter 9 forms a substantive part of the overall report, presenting as it does the findings of the cost-benefit analysis that took place in Mauritius in some detail; the chapter also includes broad conclusions from the Mauritius case study.

The case study of Vanuatu is presented in chapters 10 to 12, which include an introduction to the IFS sector in the country, its regulation and supervision and a summary presentation of the findings from the questionnaires, interviews and workshop.

The final chapter, chapter 13, presents a synthesis of the three country case studies, including a summary analysis of the overall costs and benefits of enhancing the regulatory regime for international financial services to the public and private sectors in Barbados, Mauritius and Vanuatu, and general implications for the countries' international financial centres. The chapter goes on to formulate some broad conclusions, emphasising the importance of further research to assess the developmental impact of recent international tax and AML/CFT initiatives to the much larger number of IFCs worldwide.

Notes

1. See FIRST website: http://www.firstinitiative.org/ [accessed 15 February 2008].
2. See Financial Action Task Force website: http://www.fatf-gafi.org/ [accessed 15 February 2008].