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Incremental Costs and Benefits of Enhancing the IFS Regulatory Regime in Barbados

4.1 Incremental costs of adopting new international regulatory standards

Barbados has continued to maintain its reputation as a well-respected international financial services jurisdiction with high regulatory and supervisory standards, despite being listed by the OECD as a ‘tax haven’ in 2000. Indeed, without having to make any commitments to the OECD, Barbados was removed from that list in 2002 and was subsequently identified as a significant international financial centre (IFC) in the OECD report *A Process for Achieving a Global Level Playing Field*¹. As a result, Barbados was invited to participate in the Global Forum on Taxation and has been involved in providing information on transparency and exchange of information. It should also be noted that Barbados has a stand-alone information exchange agreement with the United States and in addition, all of Barbados’ double taxation agreements provide for the exchange of information on all direct taxes between the parties unless the entities involved are specifically excluded from the treaty. Barbados’ Financial Intelligence Unit (FIU) has also established formal Memoranda of Understanding with other FIUs relating to information exchange and is also part of an international network of FIUs that exchange information. These measures were all in place prior to the new international regulatory requirements.

Barbados supervisory and regulatory requirements are in keeping with international best practices and have been that way for some time. However, compliance with the new international regulatory standards, while imposing some incremental costs to the international financial services sector in the short term, has undoubtedly strengthened overall financial sector regulation and supervision in Barbados, thus further enhancing its reputation as a well-regulated IFC. To this end, Barbados implemented legislative/regulatory changes to make provision for greater disclosure of information by international companies, especially in respect of beneficial shareholders, in order to meet the additional international requirements relating to combating money laundering and financing terrorism. Service-providers were also required to provide the authorities with the know your customer/due diligence (KYC/DD) procedures followed in deciding whether to accept or reject a client and, with the assistance of the

Financial Intelligence Unit of the Anti-Money Laundering Authority, guidelines were also issued to ensure that service-providers meet the requirements of Barbados' anti-money laundering legislation.

The qualitative and quantitative survey data collected from government regulatory and supervisory agencies and private sector entities highlighted the main incremental costs resulting from the adoption of the KYC/DD regulatory requirements for compliance with AML/CFT rules. Based on the quantitative responses, the most significant costs related to the hiring of staff, the renting of additional office space and the purchasing of new hardware and software for the information technology systems needed to comply with the KYC/DD and AML/CFT initiatives. In addition, both public and private sector entities reported incurring higher costs relating to the training and retraining of staff, staff attendance at conferences and consultations with domestic accounting/auditing firms and local/foreign lawyers.

Significant non-quantifiable costs mentioned by private sector firms operating in the IFS sector were the increased burden placed on their clients in meeting the increased regulatory requirements and the additional demands placed on their own employees to ensure compliance with these requirements, which in some cases took away considerable time from other important firm-specific issues relating to growth and diversification. One regulatory agency also identified the non-quantifiable cost of being forced to be reactionary in terms of the constant diversion of resources from developmental to regulatory issues in response to OECD and other such initiatives.

Incremental costs incurred by government regulatory and supervisory agencies

Since 2000, the scope of the functions of government regulatory and supervisory agencies in Barbados have widened considerably to include, inter alia, the mandate of upholding the KYC/DD regulatory requirements for compliance with the new AML/CFT rules. In this regard, the implementation of the nine additional recommendations of the FATF, as well as the provisions of the Sarbanes-Oxley Act in the United States on corporate governance, has been given significant attention. With regard to the latter, government agencies with regulatory and supervisory oversight have reported that a number of company directors and other senior officers in the international financial services sector have embraced, implemented and are complying with the corporate governance provisions, as outlined in the Sarbanes-Oxley legislation.

The majority of government regulatory and supervisory agencies surveyed reported increased financial costs, stemming mainly from the hiring of additional staff, resulting in the need for additional office space, the purchase of new information technology (IT) systems and the cost of retraining and training personnel to effectively carry out their increased regulatory responsibilities. Most of the regulatory agencies reported having to assign additional resources to ensure compliance with the increased requirements. For instance, the Supervisor of Insurance hired an additional five persons in 2005, resulting in increased cost for wages and salaries of Bds\$183,000, rent expenses

of Bds\$43,000 and in-house training of about 126 hours. The additional persons were needed to conduct broadened regulatory audits of companies, including on-site inspections, to ensure compliance with the enhanced regulatory guidelines, including KYC/DD requirements through the use of external audits and other administrative arrangements. Other financial costs incurred by government agencies were increased expenditure each year for staff attendance at special conferences, which averaged almost Bds\$25,000 each year between the years 2000 and 2005. The costs of investment in additional information technology systems (hardware and software) for AML/CFT purchased between 2000 and 2003 was estimated by one regulator to be Bds\$122,000. Associated with these financial costs, government agencies have identified other non-quantifiable costs, such as those resulting from being more dependent on external sources for assistance, training and advice.

Incremental costs incurred by private sector providers of international business financial services in Barbados

Private sector firms appeared to be somewhat uncertain regarding some of the questions relating to the new KYC/DD requirements. These included whether the adoption of the standards was detrimental to the reputation of Barbados as an IFC, the reputation of firms operating in the IFS sector or whether the additional costs incurred were likely to increase the competitiveness of private sector firms. In addition, most firms indicated an indifference to the question of whether excessive demands were being made on the capabilities of the managerial and other staff in government regulatory agencies to properly carry out their mandate.

However, approximately 50 per cent of the private sector firms surveyed expressed the view that excessive demands were being made on firm personnel, not only to meet the new compliance requirements, but also to deal effectively with government regulatory and supervisory agencies. This required the hiring and training of more front line and back office staff, as well as the purchase of new IT systems to deal effectively with KYC/DD compliance guidelines. Most noticeably, over 75 per cent of private sector firms were of the opinion that the financial costs incurred were higher than was necessary to promote the regular business growth of the firm. This was identified as a substantial burden to firms, with 81.8 per cent of them also indicating that AML/CFT compliance had diverted their attention away from other more important matters. This also resulted in an increase in the level of costs and attention being directed to the new regulatory requirements of local government agencies, as compared to that required for more important firm-specific issues, such as diversification and firm growth. The majority of private sector respondents (77.8 per cent) agreed that the enhanced measures required significant retraining of back office staff involved in AML/CFT compliance, while 55.6 per cent indicated that significant retraining of front line personnel was necessary. A summary of the responses by private firms and regulators to the qualitative questionnaire is shown in the appendix at the end of this report.

From the responses to the quantitative survey, private sector firms reported that either additional person-hours were necessary or additional persons were hired to comply

with the new requirements for the KYC/DD guidelines. Most private sector firms indicated incurring higher wages and salaries over the five years since 2000, averaging approximately Bds\$186,000 per firm, with the majority of the hiring being undertaken since 2003. To accommodate the new staff, firms reported renting additional office space, with on average around Bds\$11,000 being spent annually on rent.

The majority of firms reported providing regular in-house training, amounting to approximately Bds\$17,000 per firm, while only two firms reported receiving additional training from attending conferences, estimated at a total of Bds\$63,000 in 2004 and 2005. One firm indicated that training was also conducted on new information technology systems for KYC/DD requirements. Most firms reported that the costs of external technical assistance by way of professional associations and advisers were about Bds\$22,000 on average, and that there were added costs resulting from consultation with local accounting and auditing firms and with domestic and international lawyers. Approximately half of the firms cited investment in additional information systems, amounting to approximately Bds\$65,000 per firm, with the bulk of spending going towards the purchase of hardware. Other costs incurred were payments for new licensing procedures, which were estimated at about Bds\$100,000 per year since 2002, as well as the costs of external audits and the satisfying of KYC requests from external regulators and auditors.

4.2 Incremental benefits of enhanced IFS regulation and supervision

The survey results on benefits were somewhat conflicting, as no discernible consensus was reached on the incremental benefits accruing either to individual private sector firms or to the domestic economy. Contrasting views were evident among government regulators and private sector service providers of IFS (i.e. accounting and auditing firms, law firms, international banks and trusts companies), but there were a few common threads within these two groupings. An important caveat is that given the limited number of responses², particularly the few quantitative responses, generalising is not possible; however, the survey results can provide some preliminary indicators.

The enhanced reputation of Barbados as an international financial centre

The general view was that the new KYC/DD compliance requirements (to meet AML/CFT compliance) enhanced Barbados' reputation as an international financial centre (IFC). Although already considered a highly reputable jurisdiction because of its maintenance of international standards of best practice, the majority of the private sector service providers surveyed (over 60 per cent) as well as the regulators, perceived that Barbados' reputation as an IFC had been enhanced by the new KYC/DD compliance requirements. Accounting firms in particular, which comprised about 15 per cent of respondents, strongly agreed that the country's reputation had been enhanced by these measures. Similarly, regulators cited the increased number of licences issued in the last few years and the continued favourable reviews of various aspects of the sector's regulatory and supervisory framework by external assessors, as evidence of this.

The pattern of responses was generally the same on the issue of whether the new regulatory requirements strengthened overall financial system regulation in Barbados, with the majority of private providers of IFS and regulators in agreement. Again, the accounting firms were strong in their views on this issue, perhaps rightfully so given their extensive exposure in the international financial market, which better positions them to ascertain the extent to which Barbados' international reputation and regulatory system had been strengthened. Indeed, the review of the financial system by the IMF (FSAP, 2003) substantiated the view that Barbados' financial system is now relatively stronger. From the regulators' perspective, initiatives like the Sarbanes-Oxley Act, which emerged from closer attention being paid by the international community to the industry, have been beneficial to the jurisdiction by providing a catalyst for positive change. According to the regulators, Sarbanes-Oxley increased awareness of the sector to effective corporate governance and brought legitimate pressure to bear on directors and senior officers of organisations in understanding that they are responsible for their actions and could be held accountable for the fortunes of the organisation.

While there was broad-based agreement that both the regulatory system and the country's reputation had benefited from these changes, there was also some uncertainty among a limited number of respondents (approximately 30 per cent) on this issue. A negligible percentage of respondents (less than 10 per cent) disagreed that the overall financial system had been strengthened and the reputation of Barbados enhanced by the new KYC/DD requirements.

Enhanced competitiveness vis-à-vis other international business jurisdictions

Perhaps, the widest divergence of views was expressed on the extent to which Barbados' competitiveness relative to other 'offshore' financial centres had improved with the new KYC/DD compliance requirements. From the survey data, approximately 30 per cent of private sector service providers felt that Barbados' competitiveness had improved, while 23 per cent were uncertain and 38 per cent disagreed. This high level of uncertainty in responses perhaps reflects the industry's inability to adequately assess the impact on business activity arising from the various measures. Separating economic effects is a highly complex undertaking requiring a notion of the counterfactual, that is, what would have obtained in the absence of these measures. This may also explain the high level of non-response to some of these questions.

In examining the composition of respondents, accounting firms were among those expressing positive views on the matter of enhanced competitiveness, while regulators and other private service providers (including legal entities) offered mixed views.

Expectedly, most entities that responded affirmatively to the question of competitive gains made by Barbados also disagreed that the new regulatory measures imposed disproportionately high costs on firms relative to the likely benefits. Yet, these entities also opined that the upgrades made to their information technology systems and the

improvement of staff capabilities may not have been necessary otherwise. This subset was mixed, comprising regulators, accounting firms and other service providers.

Similarly, the majority of respondents that disagreed on the issue of competitive gains also felt that the new regulatory measures had not imposed disproportionately high costs on firms compared to the likely benefits that could accrue. Yet, at least half of these firms suggested that the additional costs, although not disproportionately high relative to the benefits, were such that they were considering exiting the IFS business. Again, this was a mixed subset of the category of respondents (excluding legal entities) and comprised mainly service providers. This group (those disagreeing with competitiveness gains, agreeing that costs were not disproportionately high, but were high enough that leaving the industry was an exercisable option) also expressed the view that the measures made excessive demands on the managerial and staff capabilities of both government regulatory authorities and private sector firms. Regulators, although mixed in their views on the extent to which they were required to upgrade their systems and staff capabilities in a manner and at a cost that may have been necessary, were generally indecisive as to whether these demands were excessive (see appendix 1).

Over 50 per cent of entities (including regulators, but excluding accounting firms) noted that the KYC/DD compliance requirements for AML/CFT substantially increased their financial and staff costs for meeting the requirements of external auditors. The majority (over 80 per cent) considered that these new measures diverted their attention from more important matters concerning the diversification and growth of their IFS business. The latter view was also shared by some of those respondents who felt that the costs were reasonable and the measures necessary.

There was an equally mixed position on the issue of whether the costs associated with the new measures were reasonable to ensure Barbados' high reputation and increase the competitiveness of the firm as an IFS provider, with a high proportion of respondents neither agreeing nor disagreeing (61 per cent). About 20 per cent of respondents did not concur that these costs would have been necessary anyway.

The most commonly expressed view (over 50 per cent of respondents) was that the new measures required entities to undertake some retraining of staff and upgrading of their systems in a way that extended beyond what was necessary for regular business; the measures also increased costs, while diverting attention from regular business activity. Hence it could be concluded that the new requirements might have impeded business growth, albeit marginally.

Incremental flow of IFS business to Barbados

The discussion above provides some preliminary indications of the likelihood of firms experiencing any incremental flow of IFS business. Over 50 per cent of respondents to this question indicated that the KYC/DD compliance requirements for AML/CFT did not result in any increased business for the individual firms and commensurately for Barbados³. Furthermore, the majority of respondents also noted that they did not

experience any decline in business as a result of these measures, which implies that there was no material impact on business activity in most cases.

An estimated 32 per cent of firms recorded an increase in business activity associated with these new measures. A minority of respondents engaged in banking services provided estimates of the incremental benefits derived from the enhanced IFS regulatory/supervisory regime at over Bds\$2.0 million in business revenue and Bds\$1.0 million in profit. This group also noted that product/service diversification was negligible, but reported that there were improvements in information technology capacity and knowledge base in providing global international financial services, with an estimated increase in business of between 15–30 per cent.

Accounting firms constituted 15 per cent of respondents, and estimated incremental business revenue of over Bds\$200,000 (total for all accounting firms). However, this result was not fully representative of the group of accounting firms, as 50 per cent of this subset experienced an overall decline in business of 0–15 per cent and no change in customers.

Companies providing legal services accounted for a mere 7 per cent of total respondents; they, not surprisingly, reported experiencing a pickup in business of over 30 per cent, indicating a greater reliance on legal guidance in the enhanced regulatory environment. This subset also pointed to a greater geographic diversity in its customer base. Similarly, some regulators suggested that overall IFS business rose by between 15–30 per cent.

Increased growth and diversification of the IFS product and services

It is not surprising based on the above, that the majority of companies responding to the survey did not experience any increased growth or diversification of IFS products and services. Indeed, the majority of those that responded to this question disagreed that their business experienced any increase in the number of individual or corporate customers and/or achieved any product/service or geographic diversity resulting from these measures. Nonetheless, the high proportion of respondents (between 30–60 per cent) neither agreeing or disagreeing with these questions could suggest an inability to assess or separate the effects of the new measures from other influences and consequently to apportion benefit. A small number of firms (15 per cent) reported greater diversity in the geographical origin of their customers.

4.3 Overall assessment of net benefits accruing from the adoption of new international regulatory standards and strengthening the regulatory regime

The overall net benefit to the economy

The most challenging aspect of the study is the calculation of the net benefit to the Barbados economy. Conceptually, the net benefit of a policy change is equivalent to

the total benefits less total costs associated with the new measures aggregated across affected firms and industries. For the purposes of this study, estimates of the costs and benefits resulting from the adoption of new regulatory standards and strengthening the regulatory regime were requested through the survey of key stakeholders in the IFS sector. Utilising the costs and benefits from the survey data should have allowed for the calculation of a net benefit, except that most respondents did not or were unable to quantify the benefits of the new measures. Indeed, over 60 per cent of respondents did not provide quantitative estimates of net benefits, but provided cost estimates, which were perhaps easier to measure. As a result, the ensuing analysis focuses on the costs aspect.

Notwithstanding the above, the qualitative responses can provide limited estimates of the benefits, which when combined with the costs data can provide some indications of the net benefits. Firstly, over 90 per cent of respondents mentioned that the new KYC/DD regulatory requirements resulted in greater diligence at knowing their customers, their needs and their motivations. Furthermore, over 60 per cent of respondents reported favourably that the new compliance requirements enhanced Barbados' high reputation as an IFC and strengthened overall financial system regulation. Tempering these benefits, however, are the costs to individual firms, which as previously mentioned ranged from Bds\$25,000 to over Bds\$200,000 per annum per firm.

In the absence of complete data, the pertinent question is whether the costs are disproportionately higher than the benefits? About 45 per cent of respondents felt that they were not, but 27 per cent expressed the view that the additional costs were so high that they were considering exiting the international financial services business.

Even those that felt that the costs were not disproportionately higher than the benefits, cited other downside risks to doing business, such as making excessive demands on staff and diverting attention from more important matters concerning the diversification and growth of IFS business, and consequently Barbados' competitiveness as an IFS jurisdiction. This is further supported by the number of respondents (55 per cent) that noted that the new KYC/DD compliance requirements for AML/CFT increased substantially their financial and staff costs for meeting the requirements of external auditors. As previously mentioned, approximately 50 per cent considered that these new measures made excessive demands on managerial and staff capabilities. Only 22 per cent noted that these measures required upgrades to information technology systems and staff that were necessary anyway, while 77 per cent noted that they were required to spend far more than would have been necessary for regular business.

A small percentage (less than 10 per cent) lamented being inundated with requests from the authorities for money laundering information on their customers, but over 50 per cent were concerned about striking the right balance between respecting confidentiality and meeting new compliance demands. A small minority (less 10 per cent) of respondents felt that they were being required to police financial transactions in an inappropriate manner and were focusing so much on KYC/DD requirements that it was possible that they could miss other major abuses of the system. Some 23 per cent of

firms thought that the measures were more intrusive in requiring information, which irritated customers and could possibly drive them away. About 20 per cent of respondents noted that they were now more careful in dealing with regulatory and supervisory authorities, while 22 per cent considered that the measures were preventing them from meeting legitimate tax, AML and CFT concerns.

The above indicates that the new measures created some obstacles to doing business in Barbados; these could impede the future growth of the sector, but they were hard to quantify.

Government and the public sector

To the extent that some 32 per cent of companies recorded an increase in business activity resulting from the new measures, the increased earnings and profitability would have translated into higher government revenue. Indeed, the contribution of the sector to corporation tax revenue has increased over the years and is now over 60 per cent.

Another benefit arising from the increased scrutiny of the IFS sector has been the opportunity for non-OECD countries to participate in decision-making. The Global Forum identified Barbados as a significant financial centre and in the context of ensuring that the identification and review of significant financial centres was a dynamic process, invited Barbados to participate in the Global Forum. Consequently, Barbados has been involved in the process of completing a template/questionnaire on transparency and exchange of information together with all members of the OECD and other non-member participating partners. This development can only be beneficial to Barbados.

Regulators

Based on the regulators' responses to the survey, estimated incremental benefits accruing were over Bds\$100,000 per annum (across all regulators) between 2000 and 2005, arising from improved technological capacity. A marginal increase in staff efficiency/productivity was reported, with costs over the period 2000-05 around Bds\$200,000 per annum (not including the costs of additional person-hours, for which data was not provided). This would suggest a negative net benefit. Some regulators considered that the benefits to the jurisdiction were more evident from its ability to continue to attract new highly reputable business, while incurring reasonable costs in this regard.

Private providers of IFS

Most private providers of international financial services disagreed that the new measures impose disproportionately high costs on firms compared to the likely benefits that might accrue to the firm, supporting the hypothesis that the new regime may have enhanced competitiveness relative to other jurisdictions.

As indicated above, there was consensus that firms benefited from becoming better and more diligent at knowing their customers and their needs and motivations. Many firms

were unable or unwilling to provide a quantifiable estimate of the benefits, while most provided cost estimates. Based on the limited information received, incremental business revenue was estimated at over Bds\$200,000 per annum per firm with gains from increased access to foreign markets at Bds\$95,000 and with their increased competitiveness netting Bds\$30,000. These figures compare less favourably to the costs, which at the minimum were around Bds\$220,000 per firm per annum over the past five years, if only the wages and salaries incurred by most private sector firms are considered. Additional costs related to training, upgrades and rental space would have contributed significantly to overall costs, so that for the average firm the reported costs exceed the quantifiable benefit to result in a negative net benefit.

This outcome is partly substantiated by the qualitative survey, where the sentiment expressed was that the measures made excessive demands on the capability of their personnel in meeting new compliance requirements, requiring training and increased financial and staff costs not commensurate with what is necessary for regular business growth. Furthermore, about 20 per cent of these firms felt the measures imposed very high and unnecessary administrative overhead cost burdens.

Measurement problem

Given the difficulty inherent in measuring benefits as opposed to costs, which relates to disentangling the effects of different policy changes and which may be responsible for the low response rate to the incremental benefits questions, it is likely that total benefits and consequently the net benefits are understated. This is partly reflected in the indication by some respondents that they experienced increased business activity. However, it would be misleading to infer from the limited data the nature of the distribution of the benefits.

Notes

1. Report produced by OECD Global Forum meeting at Berlin, Germany, 3–4 June 2004.
2. There was a 100 per cent response rate by the regulators, but the rate of private firms was 33 per cent while that of service providers was 50 per cent. Responses to the quantitative questionnaire by all respondents was generally poor.
3. The average response rate to this question was about 50 per cent.