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Case Study Synthesis, Conclusions and Future Directions

This final chapter presents a synthesis of the results from the preceding case study reports from Barbados, Mauritius and Vanuatu. It broadly considers the costs and benefits of enhancing the regulatory regime for international financial services in the public and private sectors for these three countries, and draws out some general implications for the international financial centres under consideration. The authors end by forming a number of overall conclusions and ask readers to consider 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.

13.1 Costs and benefits to the public sector in Barbados, Mauritius and Vanuatu

Direct costs and benefits to the public sector

The most obvious direct cost to the public sector in all three countries was that of expanding existing regulatory agencies, or creating new regulatory agencies either from scratch, or rationalising and consolidating a number of fragmented regulatory authorities under a single umbrella (as was the case with the Financial Services Commission (FSC) in Mauritius). All three jurisdictions studied have set up Financial Intelligence Units (FIUs). In Barbados, the Anti-Money Laundering Authority and Financial Intelligence Unit was established in 2000, the Mauritius Financial Intelligence Unit was created in 2002 (succeeding the Economic Crimes Office set up in 2000) and the Vanuatu Financial Intelligence Unit was set up as part of the State Law Office from 2000. Expenditure on FIUs is relatively large and looks likely to grow. A joint Offshore Group of Banking Supervisors/Asia-Pacific Group on Money Laundering assessment mission to Vanuatu in March 2006 judged the one-person FIU (recommended by the IMF after a 2003 assessment) inadequate and in need of at least two more full-time staff. The Barbadian FIU is also under considerable pressure to fulfil its responsibilities with existing staff levels. In contrast, the Mauritius FIU appears to be over-staffed and over-resourced with 27 full-time staff handling an annual average of 70 suspicious transactions reports in 2004 and 2005.

Existing regulatory agencies (especially central banks) have also taken on increased supervisory responsibilities since 2000. In line with these burdens, regulatory agencies either took on more staff (the most common solution, as for example in the Reserve

Bank of Vanuatu and the Vanuatu Financial Services Commission, the FSC in Mauritius and the Central Bank of Barbados), or else stretched existing staff resources by increasing overtime and reallocating staff from other tasks to compliance (as for example in the Bank of Mauritius and the Ministry of Industry and International Business in Barbados). Of course these responses are not mutually exclusive. Some agencies have taken on more staff and sacrificed other important priorities in order to implement internationally-mandated reforms.

In general, regulators proved less likely than private firms (especially CSPs/MCs) to identify high costs resulting from the new regulatory initiatives in their responses to the questionnaires. They were more forthcoming in private interviews. There was a tendency to understate costs on the part of these agencies, for example by not attempting to assess the opportunity costs incurred when staff were switched from one priority to another (for instance, switching staff from bank capital adequacy and risk management supervision to examining whether banks were complying with upgraded AML/CFT standards). Regulators were also more likely than operators in the IFS industry to assert the existence of benefits springing from the initiatives. These were primarily said to be reputational (of which more below), but also included in some cases modest gains in IFS *industry* productivity, as well as improved *regulatory* efficiency and productivity, although no evidence was provided to support this assertion in either instance.

The impact on government revenue

In keeping with the diversity of IFCs in general, the three governments in the jurisdictions studied in this project aimed to derive different benefits from their IFS industries. Aside from general commitments to IFS as a pathway to increasing national development and prosperity, governments also gain direct revenue benefits from hosting IFCs. This revenue may be generated either directly, in terms of incorporation fees and offshore banking licences, or indirectly through general tax revenue derived from the IFS sector.

Vanuatu does not have any corporate or income tax. Although the offshore sector does contribute some Value Added Tax (VAT) and import duties, its main contribution to government revenue has been fee revenue. In early 2006, this contribution was estimated by the Reserve Bank of Vanuatu to be 5.5 per cent of total government revenue. In contrast, Barbados derives approximately 60 per cent of its corporate tax revenue from the IFS sector, despite the very low tax rates applied (between 1 and 2.5 per cent for international business companies [IBCs]). Together with the associated personal income tax and fees, the IFS industry contributes over 10 per cent of the Barbadian government's total revenue. In Mauritius, license fees paid by offshore licensees, MCs and offshore banks account for less than 1 per cent of total public revenues. However, direct corporate tax and indirect taxes (VAT) paid by MCs, global business licensees and banks providing offshore banking services (as well as direct and indirect taxes paid by their employees) were estimated to average about 5 per cent of total public revenue for Mauritius between 2000 and 2005.

What can be said about the impact of the new internationally-mandated regulations on the revenue of the small Commonwealth IFCs under comparison? After a dip in 2000–2001 in Barbados and Mauritius (attributable in the main to the direct and indirect effects of blacklisting), government revenue derived from IFS has continued to grow, albeit at a slower rate than pre-2000. In Mauritius this has been a product of an increase in the number of IBCs ('global business companies' in Mauritian parlance), but at a much slower rate in 2002–05 than was the case between 1995 and 2002. In Barbados, even though the number of active entities (primarily IBCs) has fallen from the late 1990s, the total tax take from the IFS sector has increased. Workshop participants interpreted this as extant clients (predominantly from Canada) moving more of their business to Barbados, thus generating more tax from existing firms.

Vanuatu provides a contrast in that fee revenue from IBCs (international business companies) has stayed static, while revenue from banking licences has collapsed in line with the sharp fall in the overall number of banks. Revenue from offshore banking licences declined by 91 per cent between 2000 and 2005, although the licence fee increased from US$5,000 to US$8,000. The suddenness of the decline in bank numbers in the six months after changes in legislation governing offshore banks makes the inference that this drop was caused by (rather than just coinciding with) regulatory changes relatively robust. This interpretation was confirmed by both public and private sector representatives at the workshop.

If in Vanuatu the core of offshore banks pre-2002 was 35–40, compared with only seven banks remaining in 2003, this represents a loss of approximately US$1 million in fee revenue for the period 2003–2006 (given the offshore banking licence fee of US$8,000 plus the US$750 exempt company fee). Judging by standard international rates, this imputes a loss of as much as an additional US$3–4 million in management fees and associated services for corporate service providers (CSPs) over the same four-year period. As there has not been any compensating gain in any other area of the IFS industry, overall fee revenue has declined every year after 2000, and by half in total in 2005 compared with the base year 2000 level. This represents a major economic sacrifice, given Vanuatu's development challenges and steadily escalating regulatory costs. It may be the case that Vanuatu constitutes an outlier in this sample (i.e. compared with Barbados and Mauritius) with regard to revenue. However, it may be more typical of the broader experience of other smaller Caribbean and Pacific IFCs. Once again, however, this speculative hypothesis can only be substantiated through further research.

The impact of international technical assistance (TA)

International agencies have played a substantial, but uneven, role in defraying partially the costs associated with upgrading regulatory standards. Bodies such as the IMF, World Bank, the FIRST Initiative, United Nations Office on Drugs and Crime and the Commonwealth, as well as regional bodies such as the European Union and Pacific Islands Forum Secretariat, have taken the lead in this area. Technical assistance (TA) has been of greatest significance in Vanuatu, though bodies such as FIRST and the Caribbean

Technical Assistance Centre have also been important in Mauritius and Barbados respectively.

TA has been disproportionately directed at legislative drafting and public sector training in AML/CFT and, to a lesser extent, at financing increased information technology (IT) costs for regulators. This kind of support has been much less evident in meeting the increasing recurrent (staff salaries and office overheads) costs associated with the steady expansion of regulatory agencies, leaving the countries in question to pay a substantially increased annual bill in this respect.

Net assessment of costs and benefits for the public sector

In all three countries, public sector regulators identified the new regulatory regime as making a significant and positive net contribution to the health and global image of the IFC. This belief is most clearly expressed in the sentiment that new, more stringent standards have strengthened the overall financial system and enhanced the reputation of the jurisdiction in the outside world, both with reference to multilateral standard-setting bodies and foreign investors.

This positive conclusion belies the fact that the direct and opportunity costs (hiring new staff and the relevant other costs or diverting existing staff from other duties) of the new regulatory regime have been rising much faster than any associated tax or fee revenue gain, or the overall growth in IFS business. Indeed, in Vanuatu sharply rising regulatory costs have co-existed with a precipitous decline in government revenue from the IFC, though local regulators hope that this trend will be reversed in the future.

The quantifiable benefits from implementing new regulations have been modest, with some small increases in productivity. Instead, regulators' judgment about the net benefits derived from conforming to new standards of regulation in the IFS industry rests on two crucial assumptions. The first is that meeting these standards is a *sine qua non* for competing in the global IFS market. Failing to meet these standards is not an option, being tantamount to making an exit from that market. In this sense, regulators in all three jurisdictions observed that their IFCs had no choice but to pay whatever costs were necessary for full regulatory compliance with international demands. According to this logic then, *all* the benefits derived from the IFCs have to be ascribed to the new regulatory regime, because in the absence of this regime there would be no IFC.

The second crucial point is that increased regulation has provided commensurate benefits by improving the reputation of the IFC, as evidenced in the regulators' questionnaire responses in all three countries. In turn, reputation is seen as one of the most, and probably *the* most, important single factor in determining the competitiveness and viability of the IFC. The question of reputation is examined in further detail below. However, it is worth noting the anomaly that despite respondents in the public sector being confident about the increased standing of their IFC generated by increased regulation, they were generally unable to identify any tangible benefits accruing to the competitiveness or growth of the IFC.

This result is puzzling. If reputation is so important for competitiveness (as respondents in both the public and private sector claim), and reputation has indeed been boosted, then the ensuing competitiveness benefits should be clearly identifiable. The dearth of evidence supporting this presumed relationship in any of the countries surveyed indicates that either: reputation is less important for attracting business than generally assumed and axiomatically asserted; or that countries' reputations have not received the boost commonly assumed; or that there have been invisible competitiveness benefits that have escaped the notice of regulators and the IFS industry. The results gained from the questionnaires, workshops and interviews do not enable a definitive conclusion to be drawn from these three possibilities, although the last seems remote.

There are two other factors that have a possible bearing on this puzzle. The first is the methodological point that it may well make more sense to assess the reputation of an IFC by asking its actual or potential foreign customers than representatives from the public and private sector. Thus in discussing the question of reputation one participant suggested that consultants should catch a plane to Toronto and ask about Barbados' reputation among Canadian consumers of Barbadian IFS. After all, a jurisdiction's reputation is the standing in which it is held by outsiders, not the opinions of locals about themselves. This same point was also made at the seminar in Mauritius.

Referring to various international assessments of the three IFCs provides only a partial corrective to this bias. The IFCs singled out for unfavourable attention from the Financial Stability Forum in 2000[1] (Barbados being placed in Group 2, and Mauritius and Vanuatu in Group 3) are fiercely critical of what they see to be the arbitrary way in which this ranking was generated. Similarly Barbados and Vanuatu took a strongly negative position in response to being labelled as 'tax havens' by the OECD in June 2000, and in Vanuatu's case as an 'unco-operative tax haven' in April 2002. On the other hand, Barbados and Mauritius are more likely to endorse the positive conclusions reached by the IMF in the context of its Financial Sector Assessment Programs (Vanuatu received a far more ambivalent assessment from the IMF's 2002 module 2 assessment).

Further questioning in the regional workshops, which related to this lack of an observable 'reputation dividend' of complying with new regulatory standards, also threw up the issue of a benefit being equivalent to an 'avoided cost' i.e. whether IFCs had benefited from a positive boost to their reputation, or had merely avoided the damage of being blacklisted for non-compliance. IFC anxieties have centred particularly on the FATF's Non-Cooperative Countries and Territories (NCCT) list. In the Vanuatu workshop, most of those who had indicated on the questionnaire that the IFC had had its reputation enhanced by complying with AML/CFT standards and the like, subsequently modified their view to argue that Vanuatu had instead avoided the reputational damage associated with non-compliance and blacklisting. In the Mauritius case, those MCs and banks that had responded affirmatively when asked about whether Mauritius' reputation had been enhanced by adoption of the new regulatory standards for AML/CFT, confirmed simultaneously that its competitiveness as an IFC had been

concomitantly eroded. This combination of 'reputation-enhancement' with 'competitiveness-erosion' is a troubling one that needs to be explored.

As a final point on the net impact of reforms on the public sector, it was interesting to note that regulators rarely if ever mentioned any local benefits of regulatory reform. In the main, the standards propounded by the OECD, FATF, FSF and others are aimed at reducing financial instability, fighting financial crime and countering tax evasion and avoidance. Other potential benefits that could conceivably arise from instituting strict AML/CFT and KYC/DD procedures might be the strengthening of the domestic financial system, the reduction of local money-laundering activities, seizure of criminal assets or reducing local corruption. Yet no such benefits were seen or claimed.

Even those most enthusiastic about the financial sector reforms since 2000 saw the pay-off in terms of positive recognition (or the avoidance of sanctions) from 'outsiders'. Perhaps it is not surprising that those involved in IFCs have such a strong external orientation. On the other hand, there is also a very clear understanding – even among favourably disposed regulators – that the reforms are driven by outside rather than local priorities. In regulatory and IFI jargon, there is almost no local regulatory or industry 'ownership' of the reforms in the affected IFCs. Moreover the 'outsiders' in question, are seen as being the international, standard-setting organisations. Offshore clientele are not even given secondary importance in this regard by IFC regulators, although they are of primary importance to the IFS industry.

This lack of concern about the views of 'external clientele' on the part of all three IFC regulators seems odd, if not negligent. The IFCs do not make a living from their official external interlocutors, but from their offshore clients. This tendency to view the picture (about external perceptions of the jurisdiction concerned) so asymmetrically suggests a degree of compartmentalised institutional 'incestuousness' that IFC regulators need to guard against. There is a danger that regulators' horizons and frames of reference may be confined and blinkered to what other international regulators think of them, while their IFS industries are (correctly) much more concerned about what their clients think.

13.2 Costs and benefits to the private sector in Barbados, Mauritius and Vanuatu

All three countries saw a slowdown in the growth of their IFS sectors in 2000–2002 with the release of the OECD 'tax havens' list, the Financial Stability Forum's three-tiered assessment of Offshore Financial Centres and the FATF's Non-Cooperative Countries and Territories list. In all three cases, the IFS sectors have grown much more slowly since 2002 than they did through the 1990s. In Vanuatu the offshore banking industry has virtually collapsed, whereas in Barbados and Mauritius it has consolidated after earlier rapid growth. Data from the questionnaires and qualitative evidence gathered in the regional workshops identify both the direct effect of the blacklists, and general uncertainty about the provision of IFS from small states as being behind the pronounced drop-off or slowdown in offshore business. Growth has since

resumed in Barbados and Mauritius, albeit at a much slower rate than pre-2000, while the IFS sector in Vanuatu has yet to recover from its longer and steeper decline.

Of course, country-specific developments have also had an impact on each country's IFS sector. Barbados lost all of its US foreign sales corporations (FSCs), which numbered 2,975 in 2001, after they were ruled to be illegal by the World Trade Organization. The IFS sector in both Barbados and Mauritius suffered from uncertainties concerning key bilateral treaty relationships. Some doubts were expressed about the Canadian-Barbadian tax treaty, while the interpretation of the double tax treaty between India and Mauritius was (unsuccessfully) challenged in the Indian courts. Indonesia unilaterally (it is unknown whether this was at the behest of the IFIs) abrogated its double tax avoidance treaty with Mauritius on 1 July 2005 without providing the Mauritian authorities with any advance warning as the treaty provisions required. In addition, there were a multitude of other factors affecting the IFS industries in all IFCs, from the shock of the terrorist attacks on 11 September 2001 to changes in competitors' products and marketing. Nevertheless, despite these intervening developments, both the survey data and interview material gathered from the countries indicates that the activities of multilateral agencies and the associated impact of new regulations have been key determinants of the fortunes of the IFS sectors since 2000.

Employment trends in the industry since 2000 are difficult to assess since national statistical offices in Barbados and Vanuatu do not make a distinction between domestic and international financial services. In Vanuatu it is, however, possible to estimate that there has been modest growth in the number of people employed in the IFS industry. The increase in income tax revenue derived from the IFS in Barbados also seems to suggest that the total payroll for the IFS sector has also increased. In Mauritius, employment and payrolls in the IFS industry have increased slowly since 2002 (while the unemployment rate in the economy more generally has increased dramatically). However, as emerged during the seminar, almost all of that increase is explained by the need of MCs and offshore banks to hire more staff to cope with increased compliance demands rather than promote business expansion. The Mauritian experience suggests strongly that, while employment may have increased in the IFS sector in each country (although the evidence in Barbados and Vanuatu is incomplete), the increase was driven by the extra staff needed for compliance work outweighing those exiting the industry. Thus, while new regulations might be seen as benefiting the macroeconomy in general, they have been implemented at the expense of a significant meso-cost to the IFS industry and micro-costs to individual corporate service providers/management companies.

From the qualitative questionnaires, 75 per cent of Mauritian MCs and 47 per cent of banks had to substantially increase their staff to handle new compliance requirements, while in Barbados the figure was 44 per cent of private sector respondents in total. In Vanuatu, however, only 17 per cent of private sector respondents had to substantially increase compliance staff, though a majority of CSPs did have to retrain front line and back office staff (54 and 58 per cent, respectively).

Variations in the impact of new regulations among different sections of the IFS industry

The new regulations have, unsurprisingly, had different effects on different parts of the IFS industry in all three countries. Banks in Barbados and Mauritius have suffered less from the new state of affairs than CSPs, whose business comes from company and trust formation and related services. The relative ease with which banks have adapted to the new regulatory regime seems to stem from their exposure to much greater prudential regulation dating back well before 2000, and their earlier exposure to much tighter regulation concerning the money laundering regime. This is in contrast to CSPs (including legal and accounting firms), which until recently had a lighter regulatory burden and were not subject to any licensing system in Barbados and Vanuatu (this is currently still the case in most OECD countries); there was, however, such a licensing system in Mauritius. In Barbados and Mauritius, subsidiaries of international banks have often been able to pass on much of the cost of more stringent KYC/DD requirements to their head offices, with the increased costs of compliance being absorbed by headquarters compliance budgets.

In the context of this uneven impact between the two types of businesses, the highest costs for banks were generally new and more demanding KYC/DD requirements, while for CSPs it was the cost of establishing the beneficial ownership of corporate vehicles (primarily IBCs) for both new and existing customers.

The massive decline in Vanuatu's offshore banking sector marks it as exceptional, both in the magnitude of the decline directly attributed to the new regulations adopted in 2002 (much greater than in any other sector in any country, excluding Barbadian Foreign Sales Corporations), and in the distribution of costs, with banks being more heavily impacted than CSPs. What explains this anomalous result, particularly when Vanuatu and Barbados had a roughly similar number of banks in 2000, and both instituted equivalent changes to banking supervision and regulation?

The population of offshore banks in Vanuatu had been in decline before the launch of the FATF, OECD and related initiatives, but had stabilised at a core of 35–40 banks. The requirement of having effective 'mind and management' within the country – interpreted to mean an office with at least one full-time employee and the records of all customers – is regarded as having been crucial in the drop in bank numbers from 36 in 2002 to seven in 2003. This *mind and management* requirement was imposed even on the subsidiaries of major foreign banks, such as BNP Paribas, which subsequently withdrew from Vanuatu as a result. Unlike the situation in Barbados and Mauritius, however, far fewer offshore banks were subsidiaries of major foreign banks in Vanuatu. They were smaller independent entities established for treasury and intra-group transfer operations, often for private family companies (the two exceptions, both subsidiaries of Australian banks, gave survey responses very similar to their Barbadian and Mauritian counterparts).

Vanuatu's experience with the collapse of its offshore banking industry seems to have more in common with other East Caribbean and South Pacific IFCs (such as Antigua

& Barbuda, Dominica, Grenada, the Cook Islands or Niue) than either Barbados or Mauritius. However, further research in some of these other jurisdictions would be needed to confirm this speculation.

This exception notwithstanding, there are some common patterns evident across the three jurisdictions. Large firms have generally found it easier to bear the costs of new regulatory requirements than small firms, leading to increased pressure on small firms to exit the market. International firms have often had to meet higher standards earlier to fit in with group-wide practices and/or have been able to pass on compliance costs to the head office, whereas local firms have had to make a more rapid and wrenching adjustment.

Small CSPs have been especially hard hit by new requirements relating to establishing the true identity of those associated with offshore companies and trusts. In seeking to explain the very high proportion (27.3 per cent) of those considering exiting the IFS market in Barbados, workshop participants hypothesised that these were disproportionately small CSP firms. By contrast, the proportion of CSPs/MCs in Vanuatu and Mauritius that felt that they might need to exit the IFS business was insignificantly small, confined to one firm and two or three small MCs respectively. Questionnaire responses from Mauritius and Vanuatu confirm that CSPs were most likely to identify significant costs imposed by new requirements and least likely to identify any significant benefits. In Vanuatu, 80 per cent of CSPs adjudged the costs associated with AML/CFT to be excessive and disproportionate to any benefits. In Mauritius, 85 per cent of MCs agreed that AML/CFT compliance had required far more spending on systems, training and staff than was necessary for business purposes (in Vanuatu the figure was 66 per cent for CSPs).

To the extent that CSPs in Vanuatu have gained any new business as a result of the multilateral initiatives, this has been through picking up clients from sole practitioners and small firms that have withdrawn from the market. As a methodological (though obvious) point it is worth noting that those firms which had withdrawn from the IFS market prior to the administration of the questionnaires in late 2005 and the regional workshops March-April 2006 do not show up in either the country studies or this report, which might therefore understate substantially the magnitude of the negative impact on CSPs in general of the multilateral initiatives.

Further commonalities include the tendency to regard many new regulations as not only burdensome, but having limited relevance to fighting financial crime. In Barbados and Vanuatu, very low thresholds for suspicious transaction reporting (10,000 Barbados dollars [Bds$] and 1 million vatu [VT], or approximately US$5,000 and US$9,000 respectively) were seen as being more an exercise in creating paper work than a credible AML/CFT measure. Similarly, the requirement of establishing beneficial ownership of firms was seen as unnecessarily time-consuming, when there was a rigid insistence on, for example, old utility bills. As many participants at the Mauritius seminar put it, the new requirements did not enable them to 'know their customers' any better than they did before, nor did the 'due diligence' required enable them to

discern client motives any more clearly. The net result was to irritate clients to an unnecessary degree, which many MCs had to counteract with higher expenditures on maintaining client relations.

Competitiveness effects

By and large business respondents could not identify any competitiveness benefits resulting from the new regulations. In Barbados, Mauritius and Vanuatu a majority of firms thought that the reforms had made the IFC *less* competitive than before. In the workshops and interviews this seemed to reflect the belief that there had been substantial indirect costs in terms of business that would, but for the presence of demanding new regulatory hurdles, have been attracted. Obviously as with any counter-factual condition, assessing the magnitude and distribution of these costs poses particular difficulties.

Thus among private sector respondents only 17 per cent thought that the reforms had made Vanuatu more competitive as an IFC (with the percentage disagreeing rising to 58), and in Barbados only 30 per cent saw competitiveness advantages (while 44 per cent disagreed). In Mauritius, while a third of banks agreed that there had been competitiveness benefits (with none disagreeing and the remainder unable to say), amongst MCs only 12 per cent agreed compared with 47 per cent disagreeing.

It became apparent in the workshops and interviews that firms in all three countries were particularly concerned about losing business as a result of regulatory arbitrage, as clients sought out locations that, for example, did not subject them to the delays and inconvenience associated with strict KYC/DD procedures. Competing jurisdictions came in three types. The first involve competition from more lightly regulated onshore jurisdictions, with products such as Delaware Limited Liability Companies, Swiss private banking or New Zealand offshore trusts. The second are IFCs outside the OECD that have so far escaped being targeted by multilateral standard-setting bodies, despite their generally having less well developed AML/CFT and tax information exchange procedures. Prominent amongst such competing jurisdictions are Singapore, Hong Kong and Dubai. Finally there are those IFCs that have been targeted by international standard-setting bodies, but have either refused to comply with new standards or have adopted a more flexible attitude towards compliance, such as the Marshall Islands.

Benefits to the private sector

Perhaps unsurprisingly, the IFS industry was less convinced of the benefits of tightening up regulation than the regulators were. Nevertheless, there were many in the industry in Barbados, Mauritius and Vanuatu (in descending order of support) that saw the new regulatory regime as having generated net benefits for their IFC, if less so for their firm as such. As indicated earlier, those favourably disposed towards the recent changes saw the first (and main) benefit as being reputational, rather than in the form of tangible business advantage.

In Vanuatu, 31 per cent of private sector respondents agreed and 46 per cent disagreed with the contention that the regulatory initiatives had improved the IFC's reputation; the comparable figures from Barbados were 64 per cent agreeing and 36 per cent disagreeing (the different wording of the question in Mauritius prevents a direct quantitative comparison).

This poses the puzzle, referred to above, concerning the failure of 'reputation-enhancement' to produce any tangible effect on business as such. It raises questions about whether there was actually a positive reputational effect generated by compliance in the eyes of offshore clientele, or whether it was axiomatically assumed that because regulations had been tightened reputation had automatically been enhanced without that presumption being confirmed by customer-surveys. Alternatively, the benefit could have been seen merely as the avoidance of costs, which might have been incurred in the form of blacklisting-related reputational damage for non-compliance.

Like most regulators, some private sector participants in the workshops, especially banks, indicated that there was no alternative to meeting the new standards. Non-co-operation and non-compliance would simply have brought about the end of the IFC. The second benefit was that this outcome (the end of the IFC) was avoided. Again this poses the conceptual problem identified earlier of attributing all the benefits of the whole IFC to regulatory reforms, based on the counter-factual reasoning that if the reforms had not been undertaken, then the IFC would have failed.

These two diffuse 'benefits' aside, few other specific benefits were identified. One exception was that over 90 per cent of private sector respondents to the questionnaire in Barbados said that the KYC/DD procedure had produced useful information about their clients' needs, and this was potentially helpful for future marketing campaigns. This finding was not replicated in Mauritius or Vanuatu.

Net assessment of private sector impact

With the exception concerning the uncertainty over reputation benefits noted above, the predominant view of the private sector is that the new regulatory regime has created a net negative impact, leaving the IFS industry in each jurisdiction worse off than before. Any reputation benefits that may have accrued have yet to flow through in the tangible form of increased business activity. Variations within this picture are that CSPs/MCs in Barbados and Mauritius have been more severely affected by new regulations than banks. In Vanuatu that situation is reversed, with offshore banks suffering a major decline directly attributable to the imposition of the 'mind and management' requirement.

A final point is that for all the changes in the period 2000–2005, Barbados and Mauritius remain heavily dependent on just one key bilateral relationship each (with Canada and India respectively); this leaves the IFS sector in both extremely vulnerable in the event of problems with the relevant tax treaties. Both IFCs thus continue to be exposed to highly concentrated 'client geography risk'.

13.3 General implications for the international financial centres

Quantifying the overall net impact for the IFCs

The ideal result from a cost-benefit exercise such as this, is one global figure for each country representing in an exact dollar figure the net impact of the regulatory reforms. Arriving at such a figure is beset with threats to validity and reliability, especially given the partial questionnaire responses, the sometimes primitive state of statistical knowledge about the IFS sectors, and the reliance on counter-factual reasoning. These caveats should be kept in mind when examining the following results. In each case, however, the report has adopted conservative estimations, and has simply (but unrealistically) assumed that costs not easily measured are counted as zero.

The report can come closest to a headline figure for Mauritius. This is thanks to both the more complete questionnaire responses and the more detailed statistics collected by national authorities for the IFS sector as a whole, which allowed for more confidence in extrapolating from partial data. The global figure is that the AML/CFT reforms have cost the Mauritian public and private sector a combined total of **US$40 million** in the four-year period 2002–2005. This includes $4.8m in recurrent and non-recurrent costs for the public sector, $27.3m incurred by the MCs and $7.9m by banks. These totals represent only *direct* costs to the public and private sector; there is no allowance for business or government revenue foregone. For a variety of reasons, explained fully in the Mauritius country report, the authors believe the $40 million figure to be an underestimate, but have used it nevertheless for analytical purposes.

For Vanuatu the main challenges to coming up with a global figure were the sometimes conflicting data on public agencies and incomplete quantitative questionnaire responses from the private sector. Judging from the questionnaire responses, the total direct cost of regulatory reform to the public sector in the period 2002–2005 is about US$1.4 million, including both recurrent and non-recurrent costs. Total direct costs to the private sector, based on extrapolations from incomplete data from quantitative questionnaires, come to approximately US$1.1m in direct private sector costs, including both direct costs and extra time spent on compliance tasks. The sharp drop in offshore bank numbers from 2003 also allows for the calculation of indirect costs, specifically private sector and government revenue forgone 2002–2005. For the government the net loss of 30 offshore banks for the last three years of this period meant the loss of US$0.75m in fee revenue. Allowing for the standard prices charged for maintaining offshore banks by CSPs, this suggests a loss in business of approximately US$3m over the same period. If all these simplifications, extrapolations and assumptions are correct, this would lead to a total of **US$6.25 million** in net direct and indirect costs for the public and private sectors in Vanuatu 2002–2005.

Barbados presents an even tougher case, and no quantitative estimate of the net impact to the public sector is possible, either in terms of direct or indirect costs. Even estimating private sector direct costs relies on extrapolation from partial data, without the aid of the national statistical data that was present in Mauritius. Based on incomplete

quantitative questionnaire data, the country study suggests that the minimum average annual net loss for a single firm, taking into account only wages and salaries, is US$10,000. However, added to this are the average annual figures for in-house training (US$8,000), external technical assistance (US$11,000), IT (US$16,000) and new licensing procedures (US$50,000). Setting the costs of conferences, internal and external auditors at zero, this would give a figure of about US$95,000 per firm annually, or US$380,000 in total for a firm for the 2002–2005 period. Given the 120+ private firms in the IFS industry (including offshore banks, registered agents, trust companies, offshore insurance companies etc.), this would give an industry-wide figure of **US$45.6 million** in direct costs to the private sector in the period 2002–2005. This figure is obviously the crudest estimation of the three. However, it may represent the lower limit of net costs because: (a) it focuses on the *minimum* level of net direct costs to the private sector; (b) it disregards all indirect costs associated with business lost; and (c) it ignores all the evidence of public sector costs by assuming these to be zero. If this figure is the right order of magnitude it would represent a similar result to Mauritius, intuitively plausible since the two countries applied the same regulatory standards to their IFCs of roughly equivalent size.

Taking into account the wide disparities in economic size (Barbados GDP: US$4.84 billion in 2005 measured at purchasing power parity; Mauritius GDP: US$16.28 billion; and Vanuatu at US$0.58 billion), this would indicate that the net negative developmental impact of recent tax and AML/CFT initiatives has been proportionately heaviest on Vanuatu (per capita by far the poorest), followed by Barbados and then Mauritius. It bears emphasizing, however, that because the figures for each country include different costs, they are not strictly comparable.

Level playing field concerns

The generally negative impact of the new regulations on the IFS industries of Barbados, Mauritius and Vanuatu is particularly significant in light of 'level playing field' concerns. This principle, explicitly endorsed by the OECD in the context of its work on Harmful Tax Practices, means that all jurisdictions should commit to the same standards on the same timetable with the same consequences for non-compliance. The level playing field is particularly significant in light of the increased mobility of capital and the degree of competition between OECD and non-OECD IFCs for IFS business. Together, these factors mean that disparities may lead to unwanted regulatory arbitrage and the tendency of money launderers and financiers of terrorism to exploit the 'weakest link in the chain' in entering the legitimate financial system.

Yet at present the three developing countries under consideration actually exceed the standards of financial regulation in many OECD country IFCs. For example, in line with outside requests, all three countries have instituted licensing regimes for CSPs. Yet, major OECD countries like the United Kingdom and the United States do not have any such licensing regime in place. All three countries have either abolished or immobilised bearer shares in light of the AML/CFT risks these instruments pose.

However, in major OECD economies like Germany and the Netherlands bearer shares are still issued and mobile. In all three countries it is mandatory to establish the beneficial ownership of all companies and partnerships, yet this requirement does not apply in certain states of the US such as Delaware, Nevada and Wyoming.

Both the public and the private sector in Barbados, Mauritius and Vanuatu are keenly aware of these disparities, which are a source of some considerable resentment. As noted earlier, in Mauritius and Vanuatu in particular (and in Barbados to a lesser extent), local respondents are of the opinion that they are losing business to less onerously regulated OECD financial centres, or other IFCs like Hong Kong, Singapore and Dubai, which have neither met new standards nor been pressured to do so. The continued existence of such disparities runs counter to the effective combating of global financial crime as well as being incompatible with basic norms of fairness.

The impact of blacklisting

Even among regulators generally well disposed to the changes that have occurred since 2000 there is a general feeling in these three small island states that their IFCs had no choice but to comply with regulatory campaigns, because otherwise they would be subject to blacklisting which would in turn deal a fatal blow to the IFS sector. This view concerning the inevitability of regulatory compliance, compared with the non-option of 'death-by-blacklisting', is also shared among significant sections of the IFS industry, particularly offshore banks. As one senior regulator put it in one of the regional workshops with respect to the NCCT list, IFCs have had 'a gun to their head' in instituting a comprehensive AML/CFT system. In these quarters it is taken as almost axiomatic that no matter how poorly suited international standards are to local conditions, it is always better to comply rather than be blacklisted and thus excluded from the IFS market. Jurisdictions that have bucked this trend and refused to comply are seen as providing a cautionary tale of the fate awaiting the obdurate.

Mauritius is the clearest example of this desire to avoid blacklists above all else, making an advance commitment to the OECD in the context of the Harmful Tax Competition campaign even though the vast majority of its offshore clients were not of OECD origin. The Mauritian government agreed to remove the ring-fenced provisions of its IFS laws, put in place procedures to establish beneficial ownership of corporate vehicles and participate in a programme of exchanging criminal and civil tax information. Mauritius made these concessions just before the release of the June 2000 'tax haven' list, when only five of 41 other targeted jurisdictions had made such a commitment (the other five being Bermuda, the Cayman Islands, Cyprus, Malta and San Marino).

Barbados is an intermediate case. Like Mauritius it ensured that it avoided the FATF's list, but (uniquely) managed to face down the OECD in demanding successfully that it be removed from the 'tax havens' list without making a commitment to the slate of OECD demands. Vanuatu refused the OECD demands both in advance of the June 2000 'tax haven' and the April 2002 'unco-operative tax haven' list, before reversing its decision and complying the following year. Vanuatu was, however, quick to strengthen

AML laws and relax secrecy provisions in order to avoid being included in the FATF's first NCCT list in 2000.

The conventional wisdom notwithstanding, the short- and long-term effect of blacklists on IFCs has not been studied in a systematic manner (an area that would repay further investigation). Many non-OECD jurisdictions with IFCs (e.g. in the Middle East) have ignored FATF ministrations and representations, and yet have not seen their offshore business decline or disappear. In fact such business appears to have increased at the expense of jurisdictions like Mauritius, which shares the same geographical client base. The FATF, FSF and the OECD themselves have not assessed the overall impact of their lists; nor do they appear to have examined carefully whether their approach to blacklisting (with the implicit intimidation and threat involved) violates established norms of international dialogue, negotiation and relations and whether their approach has resulted in tilted rather than level playing fields

Some IFC jurisdictions seem to have survived despite appearing on the NCCT list with little or no observable financial damage (e.g. the Cayman Islands 2000–2001), while others have been completely unplugged from international financial networks (e.g. Nauru after 2002). Respondents in Vanuatu, who of the three countries have the most first-hand experience of the effects of blacklisting, in particular emphasise the threats to correspondent banking relationships posed by blacklisting. Many major international banks now refuse to process transactions involving Vanuatu. The domestic National Bank of Vanuatu and remaining offshore banks have had to replace their correspondent banking relationships after being cut off by foreign institutions wary of being tainted by association.

With the advent of blacklisting as a tool for compelling IFC reform, through the effective but implicit exercise of extraterritoriality in a way that might itself be illegitimate under international law, multilateral standard setting organisations like the FATF have discovered a potent instrument to overcome small state opposition by effectively bludgeoning them into submission. Whether rightly or wrongly, a large majority of respondents in the three countries surveyed saw compliance, at almost any cost, as preferable to appearing on a blacklist. Despite the suspension of the FATF NCCT list and the declining salience of the OECD's 'unco-operative tax haven' list (which now includes only Andorra, Liberia, Liechtenstein, the Marshall Islands and Monaco), current moves by the International Organization of Securities Commissions (IOSCO) to pressure non-member IFCs to adopt its principles of information exchange or suffer blacklisting suggests that this issue remains relevant.

Lack of positive recognition

There is thus a strong feeling in the three countries studied that, for them at least, there are definite negative consequences involved with defying international initiatives. Expensive compliance is widely seen as being preferable to non-compliance precipitating inclusion on a blacklist. There is considerable frustration, however, that IFCs have not received much recognition for the sacrifices they have made since 2000

in meeting new international standards in the area of IFS regulation, either by the relevant international organisations or by OECD states.

Despite having standards that generally equal and, in important areas, actually exceed those of OECD states (e.g. immobilising bearer shares, establishing beneficial ownership of companies and licensing CSPs), Barbados is singled out for especially unfavourable treatment as a 'tax haven' under the laws of OECD members including France, Hungary, Italy, Mexico and Spain. Mauritius faces similar discrimination from these same countries, as well as Portugal, while Vanuatu is listed by Belgium in addition to all the preceding states.

An additional area in which meeting international AML/CFT standards might have been expected to bring benefits to small IFCs, but generally has not, is that of AML/CFT equivalence. Many OECD/FATF member states maintain 'white-lists' of countries adjudged to have equivalent AML/CFT standards thus relieving financial intermediaries in listed countries of the expensive and time-consuming task of replicating KYC/DD already performed in the specified foreign jurisdiction. Commonly, this white-list is simply the list of FATF members. This leaves small IFCs such as the three studied in this project at a distinct disadvantage, since FATF membership is explicitly barred to developing countries that are not considered to be 'strategically important' (i.e. large and significant extant or potential economic partners). Thus even though small IFCs may have made considerable sacrifices in meeting or surpassing the AML/CFT standards of onshore countries like Australia, Canada or the United States, they do not receive the same rewards in terms of market access for their IFS industries.

Finally, positive IMF assessments (under the Financial Sector Assessment Program, FSAP) of Barbados and Mauritius notwithstanding, bodies like the OECD, FSF and the FATF have made little provision for the positive recognition of IFCs meeting international standards, as distinct from simply not blacklisting them. The FSF three-tier list, characterising Barbados and (to a greater extent) Mauritius and Vanuatu as not meeting international standards, was withdrawn in 2005 as 'no longer serving its purpose'. The OECD has never formally removed 32 of the 35 countries listed in June 2000 as tax havens (the exceptions being Barbados, the Maldives and Tonga).

The case for compensation

A further question relates to whether the three states in question, and by extension small IFCs in general, have any case for compensation (independent of technical assistance) because of the negative effects of recent regulatory initiatives. There is no case for compensation relating to AML/CFT, because there is a fundamental presumption that countries should co-operate in combating serious crime without any expectation of gain. That presumption, however, ignores the reality that, in cases like Barbados, Mauritius and Vanuatu, the expense of adopting the new AML/CFT regime far outweighs any conceivable benefit the domestic economy might derive from doing so. If indeed the new regime did result in catching money launderers or terrorists (which almost every local practitioner doubts in the extreme) the main benefits derived from

that outcome would still accrue elsewhere. The case of tax information exchange such as that specified as part of the OECD Harmful Tax Practices initiative, however, is different, and does present a strong case for OECD member states compensating small state IFCs.

Tax information exchange Double Tax Treaties are concluded on the grounds of mutual benefit for the two countries concerned. Less formal Tax Information Exchange Agreements (TIEAs) between OECD member state and small state IFCs do not provide mutual benefits, because these arrangements create a situation whereby small states bear all the expense of gathering and providing information and get nothing in return. In any given year, Barbados answers approximately 20–30 tax information requests from the US and Canada, with each case taking a Barbadian official between a day and two weeks to process. In an average year, Barbadian tax authorities would not make any information requests from US or Canadian tax authorities. However, because Barbados has formal tax treaties with both the US and Canada, the country receives substantial benefits (in terms of increased investment) that cancel out this pattern of 'one-way' information exchange. TIEAs conducted in the absence of such tax treaties or other specific benefits would provide OECD states with all the benefits (increased tax revenue) and leave small states with all the costs (collecting and providing information).

The need for tax information exchange to take place on a basis of mutual benefit is not an idea advanced in opposition to the OECD. Indeed, the OECD has explicitly endorsed this principle, most recently during the Global Forum meeting in Melbourne 15–16 November 2005. Yet the OECD model bilateral TIEA published in 2002 (which formed the basis of the Bermuda-Australia TIEA of November 2005) is poorly suited to delivering mutual benefits.

Tax information exchange between OECD and non-OECD states should be conducted on the same basis of mutual benefits as information exchange between OECD states. TIEAs by themselves do not compensate IFCs for the expense they must go to in bolstering OECD countries' tax revenues. One basis for this is for tax information exchange to take place as part of or alongside formal tax treaties with IFCs (as for example with the Austria-Belize treaty). Mauritius and Barbados have a strong interest in further expanding their tax treaty network. Where a formal treaty is not possible or appropriate (as is perhaps the case with Vanuatu) OECD countries should be willing to provide meaningful compensation to small state IFCs in return for tax information.

A good model of such is the TIEA signed between the Netherlands and the Isle of Man in 2005, providing the latter with compensatory concessions in the area of shipping and aircraft in return for providing tax information. The efforts of the International Trade and Investment Organisation (ITIO) to facilitate discussion between IFCs regarding tax treaty/TIEA negotiation strategies are also a welcome development.

13.4 Conclusions and future directions

This project has assessed the impact of recent multilateral initiatives to regulate IFS on the small state IFCs of Barbados, Mauritius and Vanuatu. The project is significant

because the IFS sector is an important source of government revenue and general economic development for each country. It is timely, and perhaps even overdue, because up until now there has been no systematic and comparative effort to assess the costs and benefits of international tax and AML/CFT initiatives on IFCs. In aiming to come up with as broad and encompassing a view of the costs and benefits to the public and private sector as possible, the project has reflected the logic of a regulatory impact assessment (RIA).

The findings contained in this report mark the distillation of the three country studies. In turn, each of these studies reflects evidence in response to questionnaires and interviews, refined and confirmed in regional workshops. Though there are inherent limits on the ability to generalise from the present sample to the universe of IFCs, the pattern of costs and benefits revealed for the three countries studied are broadly suggestive of the experiences of other similarly situated small states. However, this report strongly endorses the need for further research to confirm this inference.

The overall conclusions reached by the project are summarised in schematic form below:

- At the broadest level, the costs of the recent multilateral regulatory initiatives in the area of international tax information exchange and AML/CFT have substantially exceeded the benefits for the three small state IFCs in question. This conclusion seems robust, even taking into account the measurement difficulties of assessing benefits compared with costs.
- The greatest direct cost to the public sector has been in hiring extra staff for newly-created or expanded regulatory agencies, and the associated costs of office space, training, IT and related expenses.
- Because the IFS sector provides 5–10 per cent of total government revenue, the downturn in the industry in the wake of the blacklists of 2000 flowed through to the governments' coffers. This decline in revenue from the IFS sector (either as licensing fees or tax revenue) has been reversed in Barbados and Mauritius, but has continued in Vanuatu.
- The greatest cost to the private sector has been setting up KYC/DD mechanisms, costs generally experienced through firms having to hire new staff, divert existing staff from core business activities, participate in training activities and seminars and invest in new IT. In Barbados and Mauritius, these costs have had a much more severe impact on CSPs compared with offshore banks, while in Vanuatu this distribution of costs was reversed. General concerns were expressed in Mauritius and Vanuatu that more onerous KYC/DD requirements had produced indirect costs, as clients have sought out other, less regulated onshore and offshore investment destinations.
- A high proportion of public and private sector questionnaire respondents identified the new regulatory initiatives as producing reputation benefits for their IFC, and this was generally considered the most significant positive consequence of the

initiatives. However, both in questionnaire responses and in the workshops the same respondents were unable to identify any competitiveness or direct business benefits that might have resulted from this purported boost to reputation. The most likely explanation for this puzzling result seems to be that compliance avoided the severe or even fatal reputational damage associated with appearing on blacklists.

- The sacrifices made by the public and private sectors in all three countries to comply with the international tax and AML/CFT initiatives have largely gone unrecognised and unrewarded among multilateral standard-setting agencies (with the partial exception of the IMF) and OECD states. Despite introducing standards that are as strict as those applied onshore, and in important instances sometimes more so, onshore states have kept IFCs on national tax blacklists and have maintained barriers to market access. Although OECD states have been quick to request tax information from IFCs, they have generally been slow to match these requests with substantive compensation to ensure that an agreement along these lines adheres to the conventional principle of mutual benefits.
- Further research is required to ascertain the extent to which patterns found among these three IFCs relating to the developmental impact of recent international tax and AML/CFT initiatives generalise to the much larger number of IFCs worldwide.

Notes

1. Financial Stability Forum (2000).