



CAYMAN ISLANDS

**GOVERNMENT OF THE CAYMAN ISLANDS SUBMISSION
TO THE TREASURY COMMITTEE INQUIRY ON
OFFSHORE FINANCIAL CENTRES**

30 JUNE 2008

Updated from 25 June 2008 version

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Introduction

1. This submission is made by the Government of the Cayman Islands further to an announcement dated 30 April 2008 by the Treasury Committee (the Committee). This announced an Inquiry into offshore financial centres (OFCs) as part of the Committee's ongoing work on financial stability and transparency (the Inquiry).
2. The written evidence responds to each of the stated questions posed by the Inquiry and it is hoped that the evidence will assist the Committee in its deliberations by providing an understanding of the nature of the participation of OFCs, including the Cayman Islands, in global financial markets as it relates to financial stability and transparency.
3. The written evidence is provided under the authority of the Cabinet of the Cayman Islands via the office of the Financial Secretary.
4. The Cayman Islands appreciates the opportunity to make this submission and would like to reserve our position in respect of the ability to provide additional or supplementary written and/or oral evidence on the subject of the Inquiry.

Executive Summary

5. The Cayman Islands' submission is presented in eleven sections and covers each of the questions raised by the Inquiry. A summary of key points is provided below.

Question One – To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?

6. There is no universally accepted definition of 'Offshore Financial Centre' and no single metric of their importance. However, the evidence is that the use of financial centres by non-residents is both significant and offers advantages.
7. It has been estimated that some 80 per cent of global financial activity conducted by non-residents is conducted in OECD member countries. Other OFCs, including the Cayman Islands, collectively represent the balance. Three inter-related features of financial centres appear particularly important: **economic efficiency**, the development of **'knowledge clusters'** and **incubation of innovative financial instruments**.
8. The Cayman Islands' contribution to global financial markets is consistent with these general features. Cayman has developed a particular financial services expertise in institutional business over the past 40-plus years. This is reflected in our market position as host to a significant proportion of the world's internationally active banks, and in sophisticated investment and capital markets products and captive insurance. Centres such as the Cayman Islands have a high degree of visible, commercial integration with large OFCs which generates and supports employment, income and material and efficient global flows of investment.

Question Two – To what extent does the use of Offshore Financial Centres threaten financial stability?

9. There is no credible evidence that the use of financial centres by non-residents has created any disproportionate risk to financial stability.
10. IMF and FSF analyses of the sources of recent systemic financial instability pointed to inadequate risk management, risk assessment and transparency by a variety of market actors and disclosure and valuation gaps in accounting (IASB) and regulatory (IOSCO and Basel) frameworks. There is no suggestion in either analysis that OFCs pose an inherent threat to financial stability. All countries whether OFCs or not have a responsibility to implement the prevailing international regulatory standards as they relate to the activity regulated by their respective domestic supervisors.
11. Far from being dysfunctional threats, small tax havens/OFCs score very well on measures of governance quality. As a corollary, one would reasonably expect such jurisdictions to be inherently pre-disposed to **supporting** global financial stability.
12. As concluded by *The Economist*, 'well-run jurisdictions of all sorts, whether nominally on- or offshore, are good for the global financial system.'

Question Three – How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom's tax authorities and financial regulators?

13. As a general proposition, the requisite level of regulatory transparency is secured through adherence to international regulatory standards as promulgated by Basel, IOSCO and IAIS. Jurisdictions that comply with the relevant international standards are inherently transparent. In relation to tax transparency and as a fundamental proposition, the disclosure obligations of foreign parties under home country tax laws are not displaced by any OFC rules or practices.

Executive Summary *(cont'd)*

14. It is frequently the case that transactions structured in OFCs generate 'onshore' reporting obligations, for example by the involvement of onshore participants that are subject to regulatory and tax requirements in their home jurisdictions, by the operation of accounting standards, or by dint of the listing of issued securities on stock exchanges.
15. In the case of the Cayman Islands, the Cayman Islands Monetary Authority (CIMA) has a statutory obligation and wide associated powers under the Monetary Authority Law to cooperate with international counterparts. In the tax area, Cayman has implemented the EU Savings Directive via bilateral agreements with all 27 EU Member States on an exchange of information basis and is engaged in bilateral discussions on tax cooperation matters with a number of OECD member states under the general auspices of the OECD Global Forum on Tax Matters.

Question Four – To what extent does the growth in complex financial instruments rely on Offshore Financial Centres?

16. The IMF has credited financial innovation with diversification of risk and the enhancement of liquidity. The products falling within the cohort of innovative financial structures would likely be regarded as including 'complex financial instruments' to which the question refers, e.g., hedge funds, structured finance, securitisations.
17. There is evidence that financial innovation is stimulated by environments that allow the mitigation or elimination of dead weight cost. Complex financial instruments intended for institutional or sophisticated investors are also most likely to grow outside of a 'one size fits all' retail investor-oriented regulatory environment. In this regard, a number of jurisdictions including small OFCs, offer such an environment, either as a general feature of their regimes or via regulatory and/or tax segmentation.

Question Five – How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets?

18. The level of taxation, which in the present context must be understood as including not only headline rates of tax but also the cost of compliance with taxation regimes of ever-increasing complexity, is undoubtedly an element in explaining the position of financial centres/OFCs in worldwide financial markets.
19. The commercial sensitivity to/impact of transparency is a function of the type of financial services business being conducted. Institutional business, that is, business conducted by and for regulated financial services entities, is generally transparent. Private client business may have greater (and not illegitimate) privacy concerns.
20. Cayman has never had direct taxation; and as a specialist in institutional business, does not market based on non-transparency or indeed solely on absence of taxation.

Question Six – How do the taxation policies of Offshore Financial Centres impact on UK tax revenue and policy?

21. An extensive review of tax competition academic literature offers no clear guidance as to the level of impact of specific taxation policies on other jurisdictions. However, it is reasonable to conclude that the tax policies of all countries with significant cross-border financial services activity influence each other.

Executive Summary *(cont'd)*

Question Seven – Are British Overseas Territories and Crown Dependencies well-regarded as Offshore Financial Centres, both in comparison to their peers and international standards?

22. The Cayman Islands has established itself as a stable, sophisticated international financial services centre, providing institutionally-focused, specialised services to a global client base. The government fully associates itself with the statement in the 1999 FCO White Paper that '[i]n the long run, it is the quality jurisdictions that will prosper best. There must be no weak links which can help to undermine the international financial system'.
23. The most recent external AML/CFT evaluation (CFATF, 2007) rated Cayman as 'compliant' (the highest rating) or 'largely compliant' (C/LC) on 38 of the FATF 40+9 standards, 'partially compliant' on 10 and 'non-compliant' on one. Eighty percent of the 19 FATF countries evaluated as at February 2008 under the same standards round had combined C/LC scores lower than those of the Cayman Islands, which puts the territory in the top five, along with the US, UK, Singapore and Belgium.
24. The most current evaluation of Cayman regulatory standards was that by the IMF, published in 2005, in which Cayman fared well, except in relation to aspects of IAIS compliance for which ratings were downgraded primarily due to lack of documentation of rules and practices and staffing vacancies in CIMA's insurance division.

Question Eight – To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?

25. The Cayman Islands has criminalised terrorist financing in accordance with the 1999 UN International Convention on the Suppression of the Financing of Terrorism, via the Terrorism Law, 2003. In addition, various prior Orders in Council promulgated by the UK on behalf of its OTs, pursuant to UN S/RES 1373 and S/RES 1267, apply.
26. The most comprehensive external evaluation to date of Cayman's compliance with international CFT standards (the FATF 9 Special Recommendations) was undertaken via the 2007 CFATF evaluation. Cayman received six 'largely compliant' and three 'partially compliant' ratings; Cayman received zero 'Non-compliant' ratings.

Question Nine – What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?

27. We respectfully submit that in relation to transparency and financial stability the subject of the Inquiry there is no reason for the policy resources of HM Treasury to be consumed by OFCs that comply with international standards, except insofar as may be necessary to ensure that corresponding fair treatment for such compliance follows.

Question Ten – What has been and is the extent and effect of double taxation treaty abuse within Offshore Financial Centres?

28. The abuse of double taxation treaties tends not to occur within financial centres *per se*, but rather within corporate taxation units within capital exporting countries, including those units within the UK. Most of the smaller OFCs either do not have double taxation agreements with other countries, or have treaties which contain anti-abuse provisions and/or do not apply to their 'offshore' sectors.

Executive Summary *(cont'd)***Question Eleven – To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation?**

29. An OECD study clearly shows that the expenditure of resources on the investigation of non-compliance with foreign taxation regimes, in the absence of a domestic tax interest, occurs on the basis of treaty obligations.

Question One – To what extent, and why, are Offshore Financial Centres important to worldwide financial markets?

30. As a preliminary point of significance, and as stated in a 2007 IMF Working Paper, there is no universally accepted definition of 'Offshore Financial Centre' (OFC) and 'an empirical framework for uniform classification [of financial centres] does not exist'.¹ A recent attempt at identifying a relatively objective metric based on exports of financial services produced an OFC population that includes Hong Kong, Luxembourg, Malta, Singapore, Switzerland and the UK.² The lack of a consistently applied objective definition will necessarily affect any interpretation of evidence regarding OFCs.

31. There is more concord in relation to the origin of OFCs: as summarised by the Financial Stability Forum (FSF) –

*The main contributing factor identified for the historical growth of offshore banking and OFCs was the imposition of increased regulation (reserve requirements, interest rate ceilings, restrictions on the range of financial products, capital controls, financial disclosure requirements, high effective tax rates) in the financial sectors of industrial countries during the 1960s and 1970s.*³

The FSF report goes on to cite as an example the growth of London as the largest offshore banking centre as being directly linked to regulations imposed on the US banking sector over the period 1964-1979.

32. There is no single metric of the importance of OFCs. However, the evidence is that the use of financial centres by non-residents is both significant and offers advantages. The IMF has reported that some 60 per cent of global financial activity conducted by non-residents passes through London, New York and Tokyo.⁴ Biswas has noted that some 80 per cent of global financial activity conducted by non-residents is conducted in OECD member countries.⁵ In relation to London itself, the then UK Chancellor observed in 2006 –

*The capital is already home to 20 per cent of all cross-border lending, 30 per cent of world foreign exchange turn-over, 40 per cent of over-the-counter derivatives trades and 70 per cent of the global secondary bond market.*⁶

Other OFCs (21 by Zoromé's estimation, and up to 70 by that of others⁷), including the Cayman Islands, collectively represent the balance. In fact, there is a significant degree of integration, as typically the large centres are 'wholesalers' to the smaller ones and frequently transactions and activity involve multiple jurisdictions. For instance, a Cayman law firm might receive instructions from a US law firm to set up a fund to invest in mid-cap Indian and Asian companies, sponsored by a US investment manager; or instructions from a European law firm to set up an aircraft financing structure for the purchase by an Asian airline of aircraft from a European seller, financed by a European bank.

¹ Zoromé, A., 'Concept of Offshore Financial Centers: In Search of an Operational Definition', IMF Working Paper 07/87, April 2007, p.3.

² Ibid, p.19

³ Financial Stability Forum Report of the Working Group on Offshore Centres, April 2000, p.8

⁴ Biswas, R., 'Introduction: Globalisation, Tax Competition and Economic Development' in R Biswas (ed.) *International Tax Competition Globalisation and Fiscal Sovereignty* (Commonwealth Secretariat, London, 2002). Indeed The City of London has long self-identified as a major supplier of cross-border financial services, as have centres such as New York and Tokyo.

⁵ Biswas, R., 'International Trade in Offshore Business Services: Can Developing Countries Compete?', in R. Biswas(ed.) *ibid*, n4, p.112.

⁶ G. Brown, 'The right way to help the City thrive', the Financial Times, London, 18 October 2006

⁷ Tax Justice Network, 'Tax us if you can', briefing paper, September 2005. The TJN includes the UK in its list.

33. In terms of advantages, three inter-related features of financial centres appear particularly important. The first feature relates to **economic efficiency**. Efficiency in relation to financial centres is significantly influenced by cost. The minimization of 'dead weight cost' allows for capital to be mobilised and applied in an economically efficient manner which increases returns to investors. Successful financial centres tend to have specialised regulatory regimes or carve-outs that limit such dead weight cost in relation to cross-border economic activity.⁸ Thus, in the 1950s the UK exempted non-sterling transactions conducted through the City involving non-residents from the administrative burdens associated with exchange controls applied in relation to cross-border sterling transactions.⁹ This carve-out in association with contemporaneous increasing dead weight cost in other jurisdictions provided a significant stimulus to the development of the Eurobond market in the UK.¹⁰ It also created the opportunity for UK-based financial institutions to gain synergies from the establishment and use of facilities in other offshore centres, including the UK's Caribbean colonies and the Crown Dependencies, for financial structuring. The operations in these other centres functioned as collectors and conduits to facilitate the flow of money back to London. Such conduits provided, *inter alia*, access to hard-currency linked investments in the UK.¹¹
34. In a 2005 Institute of Economic Affairs paper Teather observes, *inter alia*, 'a highly imperfect international system for the prevention of double taxation' and points out that 'tax haven jurisdictions' (by which he refers to the geographically small OFCs targeted by the OECD's 'Harmful Tax Competition Initiative'), by providing a tax neutral platform [and thereby minimising dead weight cost] –
- '...make international capital markets more efficient and in many cases make international pooling of capital possible when it would otherwise be prevented by lack of coordination of cross-border tax and investment regulations. By doing this they increase the amount of available international investment capital, and enable it to be invested in the most profitable companies, whatever country they are in, without the distortions caused by the need to avoid double taxation.'*¹²
35. Second, successful financial centres develop a concentration of financial expertise, so-called '**knowledge clusters**'. The expertise found in knowledge clusters increases commercial certainty and creates economies of scale beneficial to the smooth functioning of financial markets. Thus, the City of London now accounts for some 80 per cent of European hedge fund management activity.¹³ Similarly, the Cayman Islands provides the domicile for more than one-third of global hedge funds.¹⁴ Such concentrations of activity would not occur unless the expertise present in these jurisdictions delivered significant value-added.
36. The role of financial centres as **incubators for innovative financial instruments** is a third important feature, as discussed in the response to Question Four.

⁸ Shaviro, D, 'Some Observations Concerning Multi-Jurisdictional Tax Competition' in Esty, D.C. and Geradin, S, *Regulatory Competition and Economic Integration: Comparative Perspectives*, Oxford University Press, Oxford, England, 2001, p.4.

⁹ Palan, R, 'Trying to Have Your Cake and Eat it: How and Why the State System has Created Offshore', (1998) 42 *International Studies Quarterly*.

¹⁰ Similarly, the removal of exchange control in the Cayman Islands in 1966 combined with the introduction of a regulatory regime for banks and trust companies stimulated the development of Cayman as an international banking centre.

¹¹ Stoll-Davey, C. 'Global Comparison of Hedge Fund Regulations', doctoral thesis, University of Oxford, 2008, pp. 11, 128, citing also Picciotto, S., 'The End of Offshore? Regaining Public Control of Finance and Taxation in the Era of Globalization', 1999.

¹² Teather, R., 'The Benefits of Tax Competition', Institute of Economic Affairs, London, 2005, p.32. This does not mean, as also noted by Teather, that the investment is not taxed; it simply means, in the context of a collective investment fund, for example, that one layer of tax (tax of the fund by the fund domicile) of the potential three layers of tax (the other two being tax of the profits or dividends of the company-target of the investment and tax of payments to fund investors) is removed.

¹³ *Hedgeweek*, 'London Hedge Fund Services' Special Report, January 2008, p.22.

¹⁴ *Ibid*, n11, p.95.

37. The extent and importance of the Cayman Islands' contribution to global financial markets is consistent with these general features. Cayman has developed a particular financial services expertise in institutional business over the past 40-plus years. This is reflected in our market position as host to a significant proportion of the world's internationally active banks, and in sophisticated investment and capital markets products and captive insurance. Some further contextual information may be useful -
- In relation to the banking sector, Cayman's banks are global and most notably deal virtually exclusively with institutional vs. individual deposits (see charts 1 and 2 [p. ii in the Appendices]). In addition, according to BIS statistics, Cayman consistently ranks within the top 10 global banking centres and Cayman banks participate in a significant proportion of the 17 per cent of global bank liabilities attributed to BIS-designated 'offshore centres' (see charts 3a and 3b and chart 4 [pp. iii-iv]). Chart 5 (p. v) illustrates the interconnected character of banking centers within the global financial system.
 - In relation to the investment funds sector, CIMA statistics as of December 2006 indicate that the 81 per cent of reporting funds had a collective assets under management of US\$2.3 trillion (without filtering for inter-investment activity to exclude double-counting), with North American fund managers managing the majority of the funds (see chart 6) and 49 per cent having a minimum initial subscription of US\$1 million or more (see chart 7 [pp. vii]).
 - In relation to captive insurance, Cayman ties with the US state of Vermont as the second-largest domicile, with North America as the dominant risk location (see charts 8 and 9 [pp. viii]).
 - In relation to international debt securities, BIS statistics indicate that Cayman issuers account for the majority of the 7 per cent 'offshore' share (the 'developed country' share being by far the largest, at 86 per cent) as shown in chart 10 [p. viii]).
38. Our client-base is global and spans major international companies, financial institutions and governments.¹⁵ Typical transactions include the formation of: investment funds for US, UK, Latin American and Asian fund managers; holding companies for listed public multinationals; aircraft financing structures; note re-packagings, securitisation and structured finance vehicles¹⁶; capital-raising vehicles for major banks; joint ventures, mergers and restructurings for major multinationals; and catastrophe bonds¹⁷.
39. In addition to a tax neutral platform and depth of professional expertise, specific reasons for the use of the Cayman Islands include –¹⁸:

¹⁵ Quasi-governmental agencies such as the US Overseas Private Investment Corporation (OPIC), The Export-Import Bank of the United States, and the World Bank's International Finance Corporation also support the use of Cayman Islands' structures for the commercial flexibility and certainty they provide in the context of transactions involving developing or emerging markets.

¹⁶ For example, the public-private finance arrangement for the upgrade of part of Peru's 960-kilometre northern toll-road network involved a Cayman Islands structure.

¹⁷ For example, in May 2006 the Government of Mexico issued a US\$160m cat bond via CAT-Mex, a Cayman Islands special purpose vehicle. In a significant innovation, the first multi-peril cat bond to cover flood risks (river floods in Great Britain), part of a US\$1 billion programme involving Allianz and Swiss Re, was structured in the Cayman Islands (Blue Wings Ltd).

¹⁸ See similar City of London benefits list: e.g. foreign ownership encouraged; effective, proportionate regulation; a consistent, politically neutral legal system that is widely used and understood globally, and confers confidence; a favourable tax environment; a wealth of talent and expertise and a regulatory framework that supports innovation. (www.thecityuk.com).

- a. Recognised, politically neutral legal system, with final appeal to the Privy Council in London;
 - b. Commercially responsive and responsible regulatory framework that complies with international standards;
 - c. Flexible and sound business statutes that produce robust and recognised vehicles for ease of international, multi-jurisdictional transactions;
 - d. Strong legal protections for investors and creditors; and
 - e. Absence of exchange control.
40. All of the 'Big Four' audit firms have sizeable offices in Cayman as well as most of the other firms within the top 10 hedge fund audit firms, and most of the top 10 fund administrators have offices in Cayman as well; and two Cayman law firms rank within the top five firms for hedge fund counsel by number of funds.¹⁹ The majority of the world's top 50 banks have branches or subsidiaries in the Cayman Islands.
41. It should be evident from the foregoing as well as our responses to the other questions below that the reasons for use, and corresponding success, of Cayman's financial services sector do not reside in secrecy or non-transparency or substandard regulation. Centres such as the Cayman Islands have a high degree of visible, commercial integration with large OFCs such as London and New York which generates and supports employment, income and material and efficient global flows of investment, to the benefit of all the economies involved.

Question Two – To what extent does the use of Offshore Financial Centres threaten financial stability?

42. There is no credible evidence that the use of financial centres by non-residents has created any disproportionate risk to financial stability. This conclusion in relation to the smaller financial centres is supported not only by the finding of the Financial Stability Forum in 2000 that the small-jurisdiction OFCs it focused on 'do not appear to be a major causal factor in the creation of systemic financial problems',²⁰ but also by the more recent findings of the IMF on regulatory performance of OFCs from its OFC assessment programme launched in 2000/1 that, '[c]ompliance levels for OFCs are, on average, more favourable than those for other jurisdictions assessed by the Fund in its financial sector work'.²¹
43. The period of financial instability that began in late July 2007 is a valuable source of empirical evidence: according to the IMF, this instability constitutes an important test of complex structured finance products,²² which are often domiciled in OFCs. The IMF analysis does not attribute to the legal form or domicile of structured finance and securitisation products or indeed of hedge funds any contributing role. Rather, it identifies the systemic financial stability concerns as arising from inadequate risk management, risk assessment and transparency by a variety of market actors and disclosure and valuation gaps in international accounting and regulatory frameworks.²³

¹⁹ Hedge Fund service provider ranking are per the Lipper Hedgeworld Service Provider League Tables, 2007 Edition.

²⁰ Ibid n3, p.1. It is not disputed, as the FSF goes on to posit, that were OFCs to exhibit serious deficiencies in the implementation of international regulatory standards, that they could in certain circumstances cause contagion. However, the same would undoubtedly hold true for any countries with significant cross-border financial activity. In relation to the Cayman Islands' performance against the regulatory standards, see response under Question Seven.

²¹ International Monetary Fund, 'Offshore Financial Centers: The Assessment Program - An Update', March 2004 [www.imf.org/external/np/mfd/2004/eng/031204.pdf]. The finding is re-confirmed in the March 2005 update, which covered an additional 13 OFCs, for a total of 41. The 41 OFCs are small countries.

²² International Monetary Fund, 'Global Financial Stability Report: Containing Systemic Risks and Restoring

Financial Soundness', April 2008, p.80.

²³ Ibid, executive summary and ch.2

44. The FSF has also assessed the factors underlying the same market turmoil and concluded that a long period of benign economic and financial conditions vastly expanded the appetite for, and consumption of, risk and leverage but outpaced the capacity of borrowers, intermediaries and investors to manage the associated liquidity and concentration risks posed by a general macroeconomic downturn.²⁴ The corrective action to achieve resilience recommended by the FSF includes the strengthening of international regulatory standards by the relevant standard-setters (primarily the Basel Committee on Banking Supervision²⁵ and IOSCO), the development by the IASB of improved accounting and disclosure standards for off-balance sheet vehicles, the improvement by credit rating agencies of the quality of the rating process and improvements in internal risk management and disclosure by market participants.
45. Similar conclusions were reached in a prior test of the financial system. According to the Chairman of the US Federal Reserve, 'the collapse of Long-Term Capital Management (LTCM) in 1998 precipitated the first in-depth assessment by policymakers of the potential systemic risk [specifically in relation to leverage] posed by the burgeoning hedge fund industry'.²⁶ LTCM was domiciled in the Cayman Islands and managed out of the US. Certain commentators have alleged that the LTCM near-collapse was due to tax haven lack of regulation and secrecy.²⁷ The analysis and conclusions of the US Federal Reserve Chairman differs strikingly.
46. In reviewing the responses to and lessons learned from the LTCM event, Chairman Bernanke stated –

*The primary mechanism for regulating excessive leverage and other aspects of risk-taking in a market economy is the discipline provided by creditors, counterparties, and investors. In the LTCM episode, unfortunately, market discipline broke down... Together with the admittedly extraordinary market conditions of 1998, [broker-dealer, bank and investor] risk management lapses were an important source of the LTCM crisis.*²⁸

While noting (with some prescience) that some concerns about counterparty risk management remained relating to the measurement of counterparty exposure in the context of an increasing volume of complex transactions, he went on to confirm the effectiveness of the policy responses implemented. Such responses included measures by US banking and securities regulators (including issuance of guidelines and enhanced monitoring) to ensure that banks and broker-dealers implemented systems and procedures to strengthen market discipline; and the industry-led development of counterparty risk management guidelines.²⁹

47. As in the case of the review of the 2007 instability by the IMF and the FSF, informed and authoritative analysis did not point to domicile offshore or alleged 'offshore secrecy and lax regulation' as a source of systemic risk. Chairman Bernanke's concluding remarks, which are also worth citing, were: 'In the final analysis, authorities cannot entirely eliminate systemic risk. To do so would likely stifle innovation without achieving the intended goal.'

²⁴ Financial Stability Forum, 'Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience', 7 April 2008.

²⁵ The IMF report (ibid, n22, p.82) states that '[f]urther refinement and careful implementation of Basel II would substantially reduce the current gaps.' The Cayman Islands Monetary Authority already has a Basel II implementation project in place to phase in the standards, as permitted, by 2010 and 2012.

²⁶ Ben S. Bernanke, 'Hedge Funds and Systemic Risk', remarks delivered at the Federal Reserve Bank of Atlanta's May 2006 Financial Markets Conference.

²⁷ e.g. Raymond W. Baker in his book *Capitalism's Achilles Heel*, John Wiley & Sons, Inc., Hoboken, New Jersey, 2005 (p.193).

²⁸ Ibid, n26.

²⁹ Internationally, the policy response involved the production by Basel and IOSCO of papers on sound practices in dealings with highly leveraged institutions. A specific policy response considered in the US but not recommended was direct and regulation of hedge funds, to which market discipline was strongly preferred: '[p]lacing the onus on market participants to provide discipline makes good economic sense...' (Bernanke).

48. It should be noted that the relevant standards and practices are neither set nor thwarted by small OFCs.³⁰ Clearly, all countries whether deemed to be OFCs or not have a responsibility to implement the prevailing international regulatory standards as they relate to the activity regulated by their respective domestic supervisors.³¹ The Cayman Islands' performance in the implementation of regulatory standards is detailed in our answer to Question Seven below.
49. In addition to the superior regulatory performance of OFCs reported by the IMF as referred to in paragraph 42 above,³² the evidence from a recent academic study by Dharmapala and Hines³³ is that far from being dysfunctional threats, small tax havens/OFCs score very well on measures of governance quality (voice and accountability, political stability, government effectiveness, rule of law, and control of corruption). The overall conclusion of the study, which covered 209 countries inclusive of the Cayman Islands and 32 other 'tax havens' is that, 'there are almost no poorly governed tax havens.'³⁴ This is a function of the reality that state success and state derangement are an unlikely combination. As a corollary, one would reasonably expect jurisdictions with high governance quality to be inherently predisposed to **supporting** global financial stability.
50. As concluded by *The Economist*, 'well-run jurisdictions of all sorts, whether nominally on- or offshore, are good for the global financial system.'³⁵

Question Three – How transparent are Offshore Financial Centres and the transactions that pass through them to the United Kingdom's tax authorities and financial regulators?

51. As a general proposition, the requisite level of regulatory transparency is secured through adherence to international regulatory standards as promulgated by Basel, IOSCO and IAIS. These sets of standards (as well as the FATF AML/CFT standards) all have components that treat with requirements for supervisory information and records, regulator's access to same and international cooperation. The transparency standards relating to international cooperation in the provision of supervisory information are implemented via bilateral or multilateral memoranda of understanding, by unilateral measures, or a combination thereof. Jurisdictions, whether deemed to be OFCs or not, that comply with the relevant international standards are inherently transparent. In the case of the banking sector in particular, the Basel Core Principles require consolidated supervision of internationally active banks by both the home and the host regulator, which in practice involves *inter alia* prior home regulator approval for the establishment of a foreign branch or subsidiary.

³⁰ The standards and practices in question would not typically fall to be implemented by the structuring domicile in the activity chain; and indeed the service provider deficiencies identified by the IMF and the FSF relate to activity typically conducted in 'onshore' jurisdictions.

³¹ Note that inherent in cross-border financial transactions is a distribution of associated service providers and activity across several jurisdictions.

³² The IMF attributes this in part to higher income levels and concern for reputation among OFCs.

³³ Darmapala, D. and Hines, J.R., 'Which Countries Become Tax Havens'©, Working Paper 12802, National Bureau of Economic Research, December 2006.

³⁴ Ibid, p.1. The study does not give individuated governance measures, but for the latest (2006) World Bank Institute measures for the Cayman Islands, see chart 11 (see p. ix of the appendices).

³⁵ *The Economist*, 'Places in the Sun: A special report on offshore finance', 24 February, 2007, p.5. In point of fact, and as particularly apposite examples of the 'good' referred to, in the context of the recent credit and liquidity pressures, Cayman Islands vehicles have provided structures for the facilitation of liquidity for investment banks; and US Treasury officials and a group of major US financial institutions had discussions on the establishment of a 'super fund' facility to provide liquidity to US markets. While the fund ultimately did not proceed for commercial reasons, the Cayman Islands was selected as the domicile for the facility.

52. In the case of the Cayman Islands, the Cayman Islands Monetary Authority (CIMA) has a statutory obligation and wide associated powers under the Monetary Authority Law to cooperate with international counterparts and while it is not a pre-requisite for cooperation to occur, has a number of Memoranda of Understanding with foreign regulators, including the UK Financial Services Authority. As noted in the response to Question Seven, in relation to the international cooperation elements under the various international standards, the IMF found a high level of compliance; and the CFATF assessed Cayman as 'compliant' or 'largely compliant' against the relevant FATF standards.
53. CIMA has provided assistance to the UK FSA on numerous occasions, over the last four-year period handling 30 requests for such assistance. Five of those requests related to FSA investigations into possible serious breaches of the Financial Services and Markets Act, including cases of insider dealing and other market abuses; the rest were routine requests for regulatory verifications.
54. In relation to tax transparency and as a fundamental proposition, the disclosure obligations of foreign parties under home country tax laws are not displaced by any OFC rules or practices. For the purposes of intellectual clarity, and in the context of characterisations of OFCs in popular commentary that assume the contrary, it must also be noted that –

There is no obligation in customary international law for tax administrations to provide tax information to, or exchange information with, foreign tax authorities absent any express treaty based obligation. Exchange of tax information between or among tax administrations typically occurs on the basis of obligations set out in bilateral or multilateral agreements, most commonly so-called double taxation treaties or agreements. Such agreements are generally voluntary and relatively comprehensive in relation to taxation rights. They also typically partition taxing rights and set out mutual benefits, whether in the form of reciprocal receipt of tax information or otherwise.³⁶

55. It is frequently the case that transactions structured in OFCs generate 'onshore' reporting obligations, for example by the involvement of onshore participants that are subject to regulatory and tax requirements in their home jurisdictions, by the operation of accounting standards, or by dint of the listing of issued securities on stock exchanges.³⁷ Many OFCs, including the Cayman Islands, also regularly report transactional statistics to the BIS and the IMF, which are published in the statistical offerings of those organisations.
56. The Government of the Cayman Islands maintains no public policy bars to the transparency and provision of information components of cooperation in tax matters and has been an active participant in the OECD process which has developed a set of technical standards in respect of transparency and exchange of information and is currently dealing with level playing field issues.³⁸ Further to an official announcement by HM Treasury that the Cayman Islands was on the UK DTA negotiation list, bilateral discussions commenced in 2004; and the Cayman Islands looks forward to concluding a DTA with the United Kingdom.³⁹

³⁶ Rose, C., 'Exchange of Tax Information: Neutrality and Inter-Nation Equity', doctoral thesis, University of Oxford, 2008, pp. 54-55.

³⁷ There are Cayman Islands companies listed on many international exchanges, including London (both LSE and AIM board), New York (NYSE and NASDAQ), Tokyo, and Dublin.

³⁸ As explained in the report produced from the 2005 OECD Global Forum meeting in Melbourne, Australia, "The level playing field is fundamentally about fairness to which all parties in the Global Forum are committed. In the context of exchange of information achieving a level playing field means the convergence of existing practices to the same high standards for effective exchange of information on both criminal and civil taxation matters within an acceptable timeline for implementation with the aim of achieving equity and fair competition." (p.1)

³⁹ The Cayman Islands entered into a tax information agreement with the US in 2001 and has an administrative unit in place, the Tax Information Authority, that acts as competent authority on tax cooperation matters, including on the EUSD reporting. The functions and powers of the Authority are established in the Tax Information Authority Law, 2005 (see www.tia.gov.ky).

57. The Cayman Islands has implemented the EU Savings Directive through domestic legislation and bilateral agreements with all 27 EU Member States and for the 2006 reporting period provided the necessary reports to the UK and 17 other member states in relation to aggregate savings income of US\$22.6m. The Cayman Islands is engaged in bilateral discussions on tax cooperation matters with a number of OECD member states under the general auspices of the OECD Global Forum on Tax Matters. This exercise is ongoing.

Question Four – To what extent does the growth in complex financial instruments rely on Offshore Financial Centres?

58. Authorities such as the IMF have credited financial innovation with diversification of risk and the enhancement of liquidity.⁴⁰ The products falling within the cohort of innovative financial structures would likely be regarded as including 'complex financial instruments' to which the question refers, e.g. hedge funds, structured finance, securitisations. In the course of its analysis of the flip-side costs of financial innovation as revealed by the market turmoil that manifested in Summer 2007, the IMF cautions that 'policymakers should avoid a 'rush to regulate', especially in ways that unduly stifle innovation...'. The IMF cautioned further that while structured finance and the originate-to-distribute model of securitisation required careful examination given their role in the market crisis, that it was important to note that securitisation *per se* was not the problem.⁴¹ Finally, the IMF suggests that continuing financial innovation is likely to design new beneficial financial instruments with enhanced transparency and risk-minimisation features.⁴²

59. There is evidence that financial innovation is stimulated by environments that allow the mitigation or elimination of dead weight cost.⁴³ Complex financial instruments intended for institutional or sophisticated investors are also most likely to grow outside of a 'one size fits all' retail investor-oriented regulatory environment. In this regard, a number of jurisdictions including small OFCs, offer such an environment, either as a general feature of their regimes or via regulatory and/or tax segmentation.

60. To the extent that Question Four may be based on the compound assumption that complex financial instruments are festerings of non-transparency and instability endemic to OFCs, the facts are that these are institutional products designed and consumed by or on behalf of mainstream 'onshore' institutional market participants and structured through an array of jurisdictions, not just small OFCs. They are also subject to such transparency requirements as are imposed by international and/or 'onshore' accounting and other standards. The negative consequences that have been associated with the inappropriate and/or ill-informed use of such vehicles arguably flowed from inappropriate business models and assumptions as well as failures to follow long-standing admonitions to investors to understand contracts prior to entering into them.

⁴⁰ In its April 2008 Global Financial Stability report, *ibid*, n22, the IMF observes, for example, that 'financial innovation and low policy rates have helped keep corporate default rates at historically low levels long after they had been forecast to rise.'(p.9)

⁴¹ *Ibid*, p.xiii

⁴² *Ibid*, p.76.

⁴³ As explained in paragraphs 33 and 34 above.

Question Five – How important have the levels of transparency and taxation in Offshore Financial Centres been in explaining their current position in worldwide financial markets?

61. The level of taxation, which in the present context must be understood as including not only headline rates of tax but also the cost of compliance with taxation regimes of ever-increasing complexity, is undoubtedly an element in explaining the position of OFCs in worldwide financial markets. Thus, the decisions of the UK, the US, Japan and more recently Canada in relation to the taxation of non-residents transacting financial services business within their respective jurisdictions undoubtedly accounts for a significant part of their success in this sector. In the UK context, this type of ‘tax competitiveness’ has been recognised by successive governments.⁴⁴ Financial centres outside of OECD countries have tended to emulate this sort of strategy.
62. The commercial sensitivity to/impact of transparency is a function of the type of financial services business being conducted. Institutional business, that is, business conducted by and for regulated financial services entities, is generally transparent.⁴⁵ Private client business may have greater (and not illegitimate) privacy concerns. Thus, jurisdictions that compete principally for institutional business such as the UK, the Cayman Islands and Bermuda are content to share tax information in the context of the EU Savings Directive (EUSD). In contrast, jurisdictions that are oriented towards private client business (e.g. Switzerland) have tended for that reason to opt for the withholding tax option under the EUSD.
63. Cayman has never had direct taxation; and as a specialist in institutional business, does not market based on non-transparency or indeed solely on absence of taxation. Rather, the lack of direct taxation and associated compliance costs in the Cayman Islands along with other factors previously discussed in the response to Question One enables the jurisdiction to provide a tax-neutral platform for the intermediation of investment capital. Unless investors are tax-exempt in their home jurisdictions, this does not result in non-taxation, as also previously explained in the response to Question One.

Question Six – How do the taxation policies of Offshore Financial Centres impact on UK tax revenue and policy?

64. An extensive review of tax competition academic literature offers no clear guidance as to the level of impact of specific taxation policies on other jurisdictions. Similarly, analysis of the conclusions of special interest groups with an interest in tax competition suggests that the assumptions made, rather than the evidence, tends to produce those conclusions.⁴⁶ It is however reasonable to conclude that the tax policies of all countries with significant cross-border financial services activity influence each other. The response to Question Nine below is also relevant.

⁴⁴ G. Brown, n6.

⁴⁵ See paragraph 55 above.

⁴⁶ As noted in: Sommerhalder, R.A., ‘Harmful Tax Competition or Harmful Tax Harmonization’, 4 EC Tax Review, 1999, pp.244-251 and Barker, W.B., ‘Optimal International Taxation and Tax Competition: Overcoming the Contradictions’, Northwestern Journal of International Law & Business, 2002, pp.161-219, 172.

Question Seven – Are British Overseas Territories and Crown Dependencies well-regarded as Offshore Financial Centres, both in comparison to their peers and international standards?

65. The Cayman Islands has established itself as a stable, sophisticated international financial services centre, providing institutionally-focused, specialised services to a global client base. The seeds of the centre were sown as early as the 1700s: two important legacies of history remain from that era – English common law and tax neutrality.⁴⁷ The Cayman Islands has always been an open, free-market economy, and from the 1960s onwards, successfully invested its “historic capital” to the benefit of the financial services sector. The sector currently accounts for approximately 30 per cent of GDP and 21 per cent of the labour force. Many of the market participants are affiliated with established international institutions.⁴⁸
66. The government fully associates itself with the statement in the 1999 FCO White Paper that ‘[i]n the long run, it is the quality jurisdictions that will prosper best. There must be no weak links which can help to undermine the international financial system.’⁴⁹ The Cayman Islands, in concert with the other Caribbean OTs and Bermuda, fully supported the FCO’s initiative in the wake of the White Paper for an independent review (conducted by KPMG in 1999/2000) of financial regulation in the six territories and continues to share the FCO’s commitment to maintaining appropriate standards, out of regard for both the UK Government’s reputation and our own.⁵⁰
67. The government takes a principled and pragmatic approach to maintaining Cayman’s position as a leading financial services centre. In terms of principle, the ‘operating manual’ is based on adherence to relevant international standards; respect for the rule of law, due process and the right to privacy; progressive reinforcement of Cayman’s international cooperation channels; and constructive engagement on international issues affecting the provision of cross-border financial services, based on a level playing field.
68. The pragmatic angle on these principles is that they promote commercial certainty and control reputation risk for global clients. The Cayman Islands fully understands and accepts that in operating a financial services centre involves serious obligations – recognizing that these obligations are not static due to evolution of international standards and the business itself.
69. It has been decidedly Cayman’s experience that adherence to relevant international standards – *not* absence of regulation – fuels sustainable growth of the sector. Like the City of London, we put a premium on promoting commercial certainty for our clients, with which a lax approach to quality and standards is not compatible.

“Efforts to achieve compliance with international standards have been top priority in the Cayman Islands... The Cayman Islands authorities have devoted substantial attention and resources to improving the country’s anti money-laundering, legal and institutional framework... An extensive program of legislative, rule and guideline development has introduced an increasingly effective system of regulation, both formalising earlier practices and introducing enhanced procedures”

IMF Report on Supervision and Regulation of the Financial Sector in the Cayman Islands (March 2005)

⁴⁷ As noted, Cayman has never had a system of direct taxation and instead employs an indirect, consumption-based taxation system.

⁴⁸ Licensees are published on the CIMA website www.cimoney.com.ky.

⁴⁹ Secretary of State for Foreign and Commonwealth Affairs, *Partnership for Progress and Prosperity: Britain and the Overseas Territories*, Cm 4262, 1999, p.23 (£12).

⁵⁰ In relation to the Cayman Islands, the KPMG Review (Cm 4855-IV, 2000, HMSO) found a seriousness in developing compliance with international regulatory standards; strong international cooperation arrangements; and a comprehensive AML framework highly responsive to international standards. (Summary of principal findings, p.6). Note that the FATF CFT standards were not within scope as they post-dated the KPMG assessment – but see Question Eight.

70. Over 20 per cent of the licensing/registration revenue from the regulated sector is re-invested into the regulator's operations (the Cayman Islands Monetary Authority), equating to CI\$14.5 million (£9m) in the 07/08 fiscal year, demonstrating the importance with which the Authority's functions are regarded. Key features of the regulatory regime include:

- *Observance of recognized and relevant international standards* – Basel, IAIS and IOSCO core principles; FATF 40+9.
- *Application of statutory 'fit and proper' criteria*⁵¹ to market participants – at entry and as an ongoing activity, the Authority performs due diligence on all directors, major shareholders, and senior officers of licensees.
- *International cooperation* – The Authority has a statutory obligation to provide assistance to overseas counterparts.⁵²

The Authority is a member of a number of regulatory bodies in the banking and insurance areas and has applied for IOSCO membership.⁵³

71. The IMF assessment of financial regulation in the Cayman Islands published in 2005 found as follows:

- *Overall* – "...[A]n extensive program of legislative, rule and guideline development has introduced an increasingly effective system of regulation, both formalizing earlier practices, and introducing enhanced procedures."
- *Banking*⁵⁴ – "The laws, rules and statements of guidance governing prudential supervision are up-to-date and generally meet international standards. The licensing process for new entrants is sound and comprehensive. Off-site monitoring and on-site inspection are well-developed and integrated..."
- *Insurance*⁵⁵ – "The measures and policies in place for insurance supervision are sound..."
- *Securities*⁵⁶ – "In broad terms, the supervisory regime reflects those of developed countries... A sound legal, taxation and accounting system appears to be in place... Regulation in accordance with the IOSCO Principles is well-implemented except in the mutual funds area."⁵⁷
- On the *international cooperation elements* under the various international standards, the assessment found the Cayman Islands 'compliant' or 'largely compliant' (Basel Core Principles); the standards 'implemented' and 'partly implemented' (IOSCO Principles) and 'largely observed' (IAIS Principles); and 'compliant' or 'largely compliant' (FATF Recommendations).

In relation to the AML/CFT portion of the IMF assessment, approximately 94 per cent of the ratings assigned were in the 'compliant' or 'largely compliant' category and 6 per cent in the 'non-compliant' or 'materially non-compliant' category.

⁵¹ This requires regard to a) honesty, integrity and reputation, b) competence and capability, and c) financial soundness.

⁵² From 2000 to 2007(June), 664 requests (80 non-routine) were handled, with assistance provided in virtually all cases.

⁵³ Namely the Offshore Group of Banking Supervisors (OGBS), the Caribbean Group of Banking Supervisors (CGBS), the Association of Supervisors of Banks of the Americas (ASBA), the International Association of Insurance Supervisors (IAIS), the Offshore Group of Insurance Supervisors (OGIS).

⁵⁴ The IMF assessed Cayman's banking supervision as "compliant" or "largely compliant" with all 30 criteria included in the 25 Basel Core Principles for Effective Banking Supervision.

⁵⁵ Of the 17 IAIS Core Principles, the IMF assessed 11 as "observed" or "largely observed" and 6 as "materially non-observed". The latter assessments were based on either a lack of staff to implement [Insurance Division was only at 60 per cent strength at the time of the assessment] or a lack of documentation of rules or practices.

⁵⁶ Of the 30 IOSCO Principles, the IMF assessed securities standards as "implemented" or "broadly implemented" for 17 principles, "partly implemented" for 8 and "not implemented" for 1, with 4 "not applicable."

⁵⁷ The exception largely related to a) absence of certain provisions relating to domestic retail/public funds, which the report acknowledges do not make up the majority of Cayman funds and b) supervisory provisions that the assessors considered should be in the Mutual Funds Law itself, instead of in the Monetary Authority Law. Both matters have since been addressed.

72. The full IMF report ('Assessment and Supervision and Regulation of the Financial Sector', in two volumes) can be accessed from www.imf.org. Since the assessment, the Authority in cooperation with government as necessary has made significant strides in addressing the IMF recommendations.

73. As required by FATF AML/CFT standards and confirmed by external assessments, the Cayman Islands' legal regime criminalises money laundering in accordance with the UN Vienna (1988) and Palermo (2000) Conventions. With the support of the FCO, the Cayman Islands was the first regionally, and among the first worldwide, to criminalise money laundering on an all serious crimes basis (i.e. not limited to narcotics crime), by the 1996 Proceeds of Criminal Conduct Law (PCCL). Money Laundering Regulations under the PCCL apply comprehensive AML/CFT obligations in relation to customer due diligence, recordkeeping, systems of internal control and suspicious activity reporting and training, on all financial business within scope of the FATF standards.

"In terms of the AML/CFT compliance culture in the Cayman Islands, it was evident to the assessors that the country in general and the financial service providers in particular all have a keen sense of awareness of AML/CFT issues. Additionally, the financial service providers displayed a healthy compliance culture, based on an appreciation of the reputational risk of AML/CFT for the jurisdiction. The strong compliance culture was also demonstrated by the financial service providers' pro-active cooperation with the authorities in implementing AML/CFT measures."

CFATF AML/CFT Mutual Evaluation/Detailed Assessment Report on the Cayman Islands (November 2007)

74. In a number of respects, the AML regime in the Cayman Islands outpaced international standards, for example, in the breadth of activity coverage ('gatekeepers' providing trust, company and other services and real estate transaction were in scope before this was the international standard); in the undertaking of retrospective due diligence on all clients existing prior to the implementation in 2000 of upgraded AML legislation; the breadth of the statutory obligation to report suspicious activity under the AML legislation; and the immobilization of bearer shares.

75. The Cayman Islands is a founding member and past Chair of the Caribbean Financial Action Task Force (CFATF), an FATF associate member body established in 1990, and has undergone to date three evaluations by that organisation (in 1995, 2002 and 2007) in addition to the external AML/CFT evaluations by KPMG (see n50), the FATF Review Group of the Americas in 2000/01 and the IMF (see paragraph 71 above). The conclusions and findings of all of these evaluations recognise and reflect Cayman's strong commitment to FATF standards. The IMF report noted that –

*The Cayman Islands financial industry and regulators have developed an intense awareness of the measure required to combat money laundering and the financing of terrorism, as a result of legal reforms and improved supervisory procedures since 2000. There is an effective regime to implement these procedures and good evidence of a developed compliance culture.*⁵⁸

⁵⁸ IMF Report Vol. I, p.7. Taking into account the IMF regulatory and AML/CFT assessments, the UK NAO November 2007 Report '[FCO]: Managing risk in the Overseas Territories' (HC 4 Session 2007-2008) also noted that '[r]egulators in the key centres of Bermuda and the Cayman and British Virgin Islands...achieved major improvements since 2000.'(p.21).

76. As previously noted, the most recent evaluation of the Cayman Islands in relation to international AML/CFT standards is that conducted by the CFATF in 2007. This was a 'third-round' evaluation, based on a more comprehensive and advanced version of the FATF standards and evaluation methodology than prevailed at the time of the IMF assessment.⁵⁹ The evaluation rated Cayman as 'compliant' (the highest rating) or 'largely compliant' (C/LC) on 38 of the 40+9 standards, 'partially compliant' on 10 and 'non-compliant' on one⁶⁰. This compares very favourably with the out-turn of the 19 FATF third-round evaluations conducted as at February 2008, where there was an average of 29 for C/LC ratings (including a high of 43 and a low of 12). Eighty percent of the 19 FATF countries had combined C/LC scores lower than those of the Cayman Islands, which puts the territory in the top five, along with the US, UK, Singapore and Belgium⁶¹. The Cayman Islands is currently working hard to address the shortfalls that were identified in the CFATF evaluation, and expects to substantially complete that work by the time of the next CFATF plenary in October/November 2008.
77. In terms of transparency standards in particular, Cayman received a rating of 'compliant', meaning that the regime was not found to have obstructive secrecy provisions that would impede effective implementation of the FATF 40+9. Cayman was also rated 'compliant' on the FATF standards relating to the transparency of legal persons and legal arrangements. This transparency performance is further reflected in the C/LC ratings achieved on the international cooperation standards.
78. The Cayman Islands' highly rated international cooperation regime is articulated in comprehensive statutory law enforcement and regulatory channels contained in the Monetary Authority Law (regulatory cooperation); the Mutual Legal Assistance Treaty (United States of America) Law; the Criminal Justice (International Cooperation) Law (CJICL); the Misuse of Drugs Law; and the Proceeds of Criminal Conduct Law (all law enforcement cooperation).
79. Since US ratification of the Mutual Legal Assistance Treaty (MLAT) in 1990, Cayman and the US have cooperated in over 250 requests for assistance under the Treaty, resulting in successful law enforcement actions.⁶² Similarly, in relation to countries other than the US, 160 requests for assistance in criminal matters have been dealt with under the CJICL over the period 2003 – 2007 (mid-year). Like the MLAT channel, the CJICL provides for a broad range of mutual legal assistance, including executing searches and seizures; providing information and items of evidence; identifying or tracing proceeds, property, instruments or such other things for the purposes of evidence; immobilising criminally obtained assets; and assisting in proceedings related to forfeiture and restitution. Assistance is available, including at the investigative stage, to all 146 Vienna Convention countries, including the UK.⁶³

⁵⁹ The FATF and FATF-style regional bodies (e.g. the CFATF) all use the same evaluation standards and methodology, requiring assessment based on over 200 criteria. The Cayman evaluation team comprised experts from the Bahamas, Canada, Jamaica, the US and the CFATF secretariat and was the first CFATF evaluation to include FATF member country experts on the assessment team.

⁶⁰ The distribution of Cayman's C/LC ratings by category of FATF standard totals is as follows: Legal System: all; Preventive Measures: 20 out of 22; Institutional and other Measures: eight out of nine; International Cooperation: all; and Nine special [CFT] recommendations: six out of nine. The single 'NC' rating was for lack of express requirements concerning correspondent banking activity. The full evaluation report is available at www.cfatf.org.

⁶¹ In terms of further peer comparisons, inasmuch as three of the subject EU member states would be classified as OFCs, the European Commission on 5 June announced infringement procedures against 15 member states for failure to fully implement the 3rd Money Laundering Directive (the UK was not in this group).

⁶² Including in relation to the Enron matter, in which a number of Cayman Islands entities were the victims of fraudulent activity centred in the US.

⁶³ The CJICL was used (as well as other statutes), for instance, to provide assistance to the Italian authorities in relation to the Parmalat matter; and as reported in the 2007 UNODC/World Bank report, 'Stolen Asset Recovery (StAR) Initiative: Challenges, Opportunities, and Action Plan', to freeze and repatriate US\$33 million to Peru in the Montesinos bribery, theft and corruption matter (pp 19-20). Assistance has been provided to the UK on innumerable occasions under the CJICL and other channels.

80. Financial services market share and quality and repute of market participants may also be taken as an indicator of the degree to which the OTs and Crown Dependencies are well-regarded.

Question Eight – To what extent have Offshore Financial Centres ensured that they cannot be used in terrorist financing?

81. The Cayman Islands has criminalised terrorist financing in accordance with the 1999 UN International Convention on the Suppression of the Financing of Terrorism, via the Terrorism Law, 2003. In addition, various prior Orders in Council promulgated by the UK on behalf of its OTs, pursuant to UN S/RES 1373 and S/RES 1267, apply.
82. The most comprehensive external evaluation to date of Cayman's compliance with international CFT standards (the FATF 9 Special Recommendations) was undertaken via the 2007 CFATF evaluation. Cayman received zero 'Non-compliant' ratings, six 'largely compliant' and three 'partially compliant'. Of the latter, the one relating to SR VII (wire transfer rules) self-corrected (as the assessors noted it would) as of the 1 January 2008 entry-into-force date for the required statutory provisions enacted in June 2007. The actions required in relation to the remaining two (SR VIII – Non-profit organisations and SR IX – cash transports) are being addressed.
83. The evidence available to us thus far is that Cayman tends not to be abused for the purposes of terrorist financing – there have been no domestic prosecutions (for want of cause) and no international requests for assistance in relation thereto; and the Financial Reporting Authority statistics for suspicious activity reports (SARs) by reason for suspicion for 2005/6 attribute 1 per cent of SARs to suspected terrorist financing, and zero for 2006/7. Notwithstanding, private and public sector vigilance will be maintained.

Question Nine – What are the implications for the policies of HM Treasury arising from Offshore Financial Centres?

84. We respectfully submit that in relation to transparency and financial stability the subject of the Inquiry there is no reason for the policy resources of HM Treasury to be consumed by OFCs that comply with international standards, except insofar as may be necessary to ensure that corresponding fair treatment for such compliance follows.
85. In respect of possible areas of examination in the context of HM Treasury fiscal policy, there is to date no convincing evidence that the existence of OFCs has caused tax takes to fall or a 'race to the bottom'⁶⁴. There is however what Sharman describes as the mirage that large amounts of tax revenue might flow from a campaign against tax havens.⁶⁵
86. Recent academic studies⁶⁶ have examined the effect of low direct tax jurisdictions on those with conventional tax regimes and produced a series of conclusions as follows.

⁶⁴ As concluded, e.g. in: Griffith, R. and Klemm, A., 'What has been the Tax Competition Experience of the Last 20 Years?', Institute of Fiscal Studies, 2004; and Council of the European Union, 'Taxation in the European Union – Discussion paper for the Informal Meeting of ECOFIN Ministers, Commission of the European Union, 1996.

⁶⁵ Sharman, J., *Havens in a Storm*, Cornell University Press, Ithica and London, 2007, p.159.

⁶⁶ e.g. Desai, M.A., Foley, C.F. and Hines, J.R. 'Economic Effects of Regional Tax Havens'©(2004) National Bureau of Economic Research [www.nber.org/papers/10806]; and Hines, J.R., 'Do Tax Havens Flourish?©', Working Paper 10936, National Bureau of Economic Research, 2004. These studies include large and small OFCs/tax havens.

- a. Firstly, open economies have incentives to tax mobile multinational firms less heavily than they do other firms, since multinational tax bases are more elastic and the efficiency costs of taxing them are greater. As a practical and political matter, it is very difficult to differentiate tax burdens in this way. Foreign tax havens may help to achieve this differentiation, since multinational firms use tax haven operations to reduce their effective tax rates; the studies observe both that such differentiation can be an optimal configuration and that countries may not realize the role of tax havens in achieving it.
- b. Secondly, the evidence indicates that the establishment of affiliates in tax havens is complementary to economic activity outside of tax havens, by facilitating investment via access to lower-cost capital: in practice, tax havens do not divert economic activity from high-tax locations in the same region; just the opposite.
87. Hines has noted that, contrary to popular rhetoric, modern research points to the legitimate role of OFCs as 'pressure valves' for the world economy, by enabling economic activity to occur which would otherwise be overly pressurized in other economies by state ownership of the financial sector, or non-competitive regulatory, tax or other policy.⁶⁷ In fact, the OECD has also acknowledged this role –

*The more open and competitive environment of the last decades has had many positive effects on tax systems, including the reduction of tax rates and broadening of tax bases which have characterised tax reforms over the last 15 years. In part these developments can be seen as a result of competitive forces that have encouraged countries to make their tax systems more attractive to investors. In addition to lowering overall tax rates, a competitive environment can promote greater efficiency in government expenditure programs.*⁶⁸

88. Similarly, in a statement for the record of the US Senate Committee on Finance, the US Treasury noted that –

*Increasingly the ability of US companies to grow and prosper depends on their ability to do business globally. In the 1960's, the decade during which many of our current tax rules regarding cross-border activities and investment were first enacted, international trade and investment flows were much less important than they are today to the US economy.... The US business tax system imposes a burden on US companies and US workers by raising the cost of investment in the US and burdening US companies as they compete with foreign companies in foreign markets.*⁶⁹

The statement goes on to outline possible areas for consideration to make US tax system less burdensome, which include, in an inherent validation thereof, fuller domestic integration of certain features that the use of OFCs/tax havens currently provide in relation to the treatment of foreign earnings by US companies.

Question Ten – What has been and is the extent and effect of double taxation treaty abuse within Offshore Financial Centres?

89. The abuse of double taxation treaties tends not to occur within financial centres *per se*, but rather within corporate taxation units within capital exporting countries, including those units within the UK. Most of the smaller OFCs either do not have double taxation agreements with other countries, or have treaties which contain anti-abuse provisions and/or do not apply to their 'offshore' sectors.

⁶⁷ Hines, J.R., presentation to STEP International Conference, Panama, May 2008.

⁶⁸ The Organisation for Economic Cooperation and Development (OECD), 'The OECD's Project on Harmful Tax Practices: The 2001 Progress Report, Paris, 2001; as cited by Teather (ibid, n12).

⁶⁹ Statement for the Record of the US Senate Committee on Finance Hearing on International Tax Reform Held on June 26 2008. (www.treas.gov/press/releases/hp1060.htm)

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90. The Cayman Islands does not currently have (nor has it ever had) a double taxation treaty with the UK. In the course of treaty talks with HM Treasury, anti-abuse protections have been discussed.

Question Eleven – To what extent do Offshore Financial Centres investigate businesses and individuals that appear to be evading UK taxation?

91. The basis on which countries with significant financial centres collect and provide tax information to foreign tax authorities has been the subject of a recent and comprehensive study by the OECD.⁷⁰ The study clearly shows that the expenditure of resources on the investigation of non-compliance with foreign taxation regimes, in the absence of a domestic tax interest, occurs on the basis of treaty obligations. This appears to be the practice of the United Kingdom with respect to non-resident persons with bank deposits and other financial activities in whom the UK has no tax interest. It appears sensible and prudent to the government of the Cayman Islands to maintain the same policy approach.

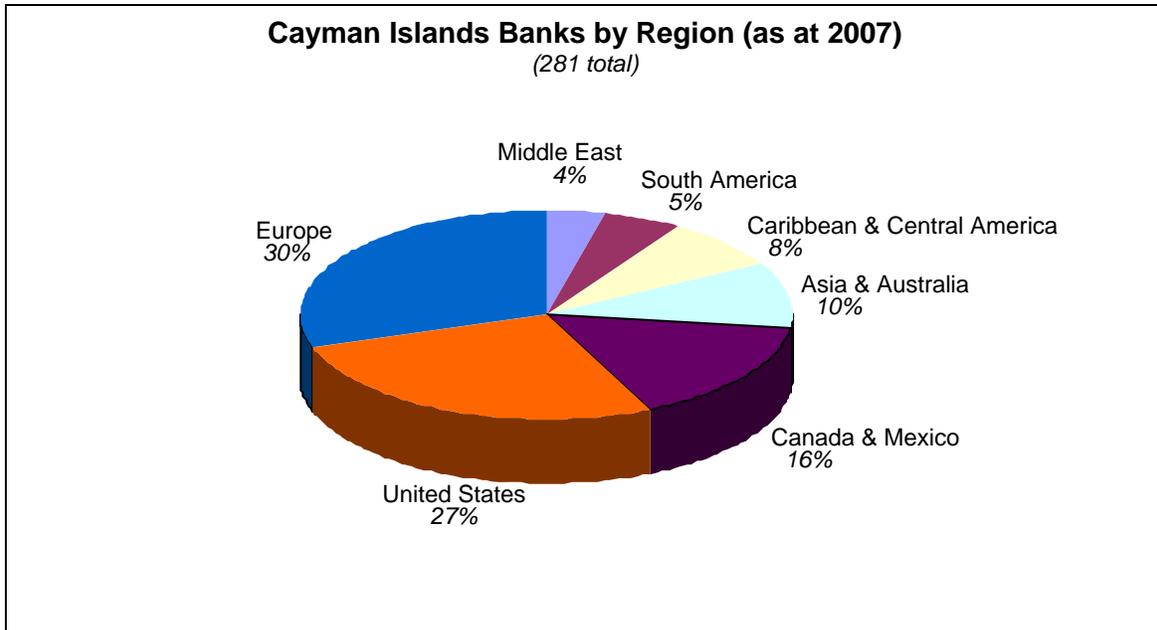
⁷⁰ OECD, Tax Cooperation: Towards a Level Playing Field – 2007 Assessment by the Global Forum on Taxation, Paris, 2007.

LIST OF ABBREVIATIONS/ACRONYMS

AML	Anti-money laundering
AML/CFT	Anti-money laundering/combating the financing of terrorism
ASBA	Association of Supervisors of Banks of America
Basel	Basel Core Principles for Effective Banking Supervision or associated Basel Committee
BIS	Bank for International Settlements
CGBS	Caribbean Group of Banking Supervisors
CFATF	Caribbean Financial Action Task Force
CFT	combating the financing of terrorism
CIMA	Cayman Islands Monetary Authority
CJICL	Criminal Justice (International Cooperation) Law
DTA	double taxation agreement
EU	European Union
EUSD	European Union Savings Directive
FATF	Financial Action Task Force
FATF 40+9	Financial Action Task Force 40 Recommendations on Money Laundering and 9 Special Recommendations on Terrorist Financing
FCO	Foreign & Commonwealth Office
FSA	Financial Services Authority
FSF	Financial Stability Forum
HMT	Her Majesty's Treasury
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
LSE	London Stock Exchange
MLAT	Mutual Legal Assistance Treaty
NAO	National Audit Office
OECD	Organisation for Economic Cooperation and Development
OFC	Offshore Financial Centre
OGBS	Offshore Group of Banking Supervisors
OGIS	Offshore Group of Insurance Supervisors
OT	Overseas Territory
PCCL	Proceeds of Criminal Conduct Law
SR	Special Recommendation
S/RES	Security Council Resolution
STEP	Society of Trust and Estate Practitioners
UN	United Nations
UNODC	United Nations Office on Drugs and Crime
UK	United Kingdom
US	United States

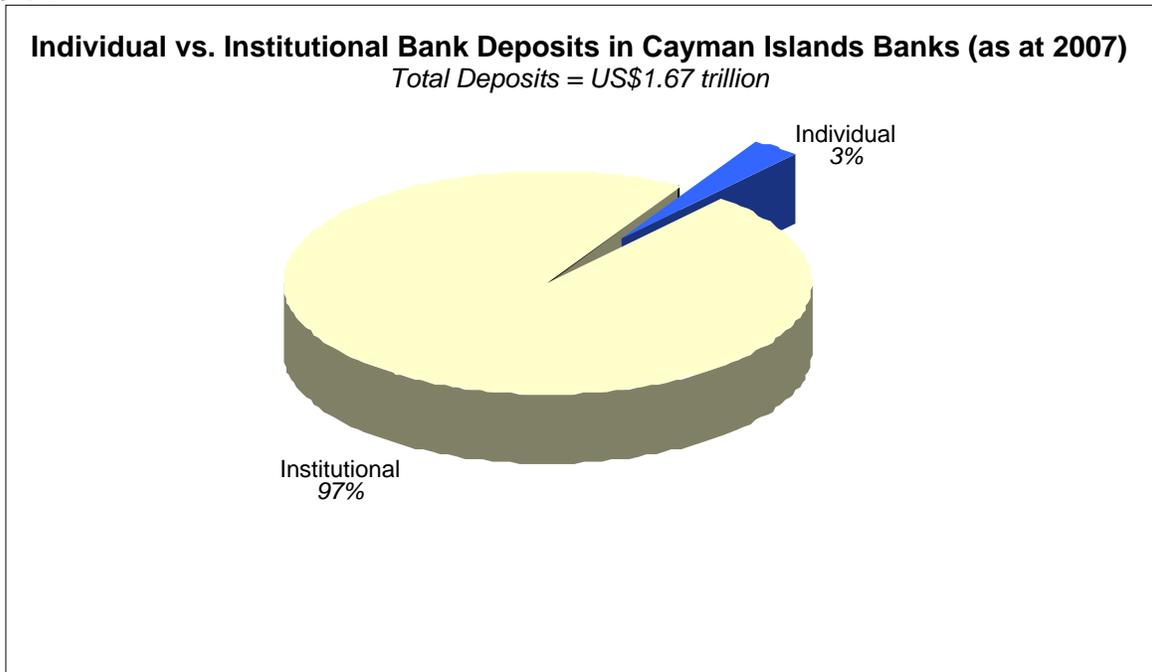
FIGURES AND CHARTS

Chart 1



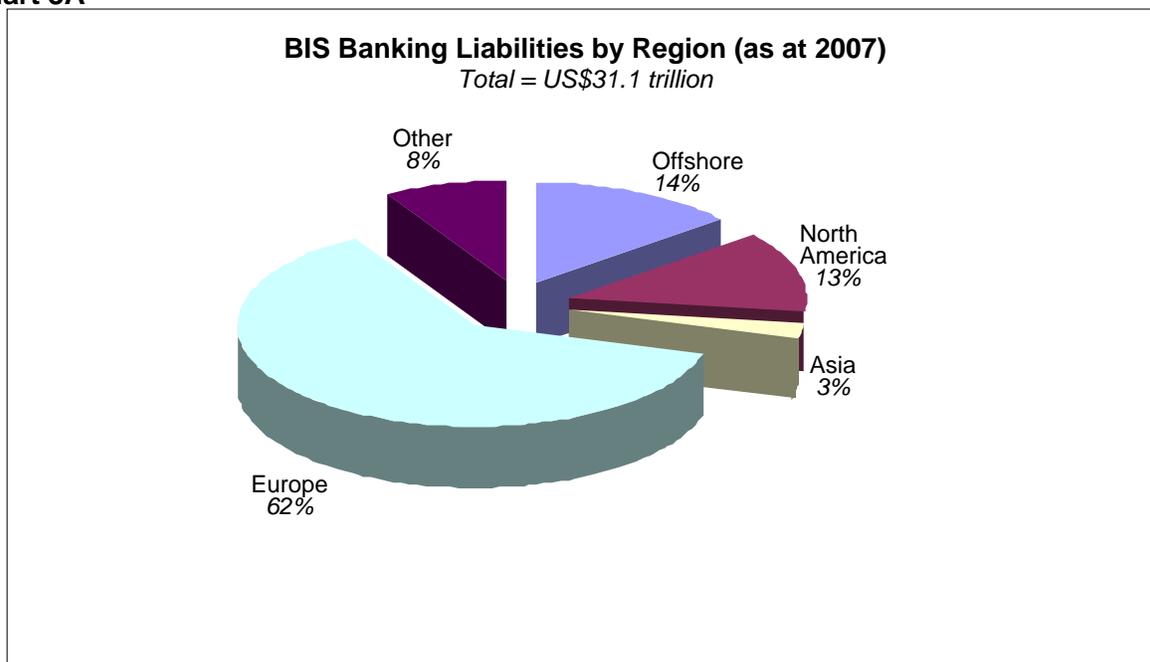
Source – Cayman Islands Monetary Authority

Chart 2

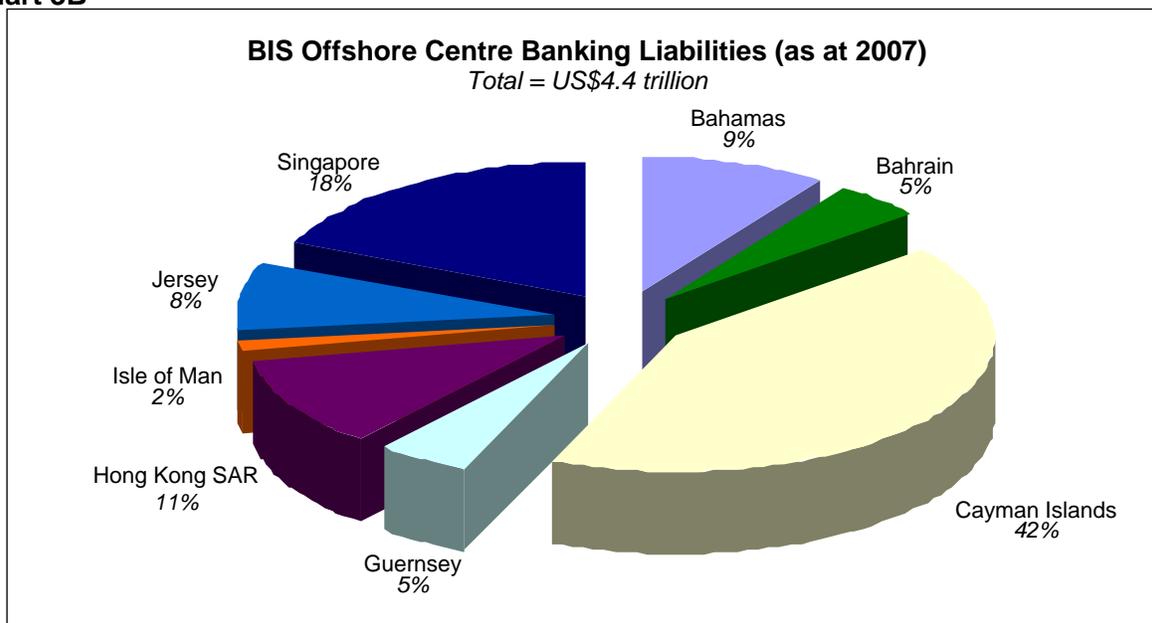


Source – Cayman Islands Monetary Authority

FIGURES AND CHARTS (CONT'D)

Chart 3A

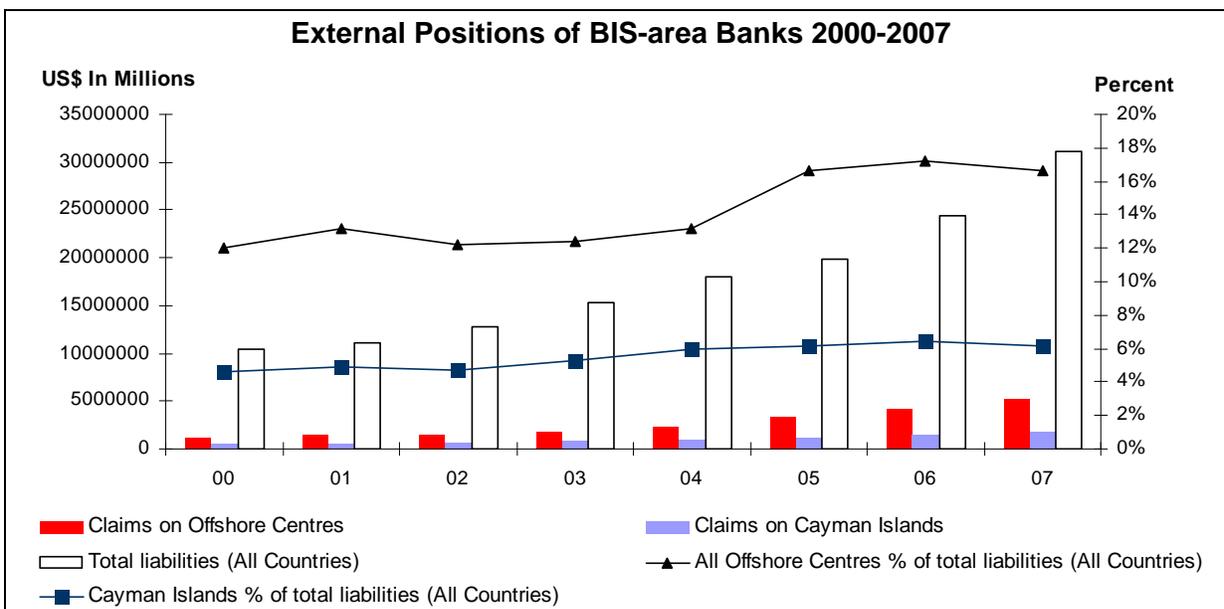
Source – Bank for International Settlements Quarterly Review June 2008

Chart 3B

Source – Bank for International Settlements Quarterly Review, June 2008

FIGURES AND CHARTS (CONT'D)

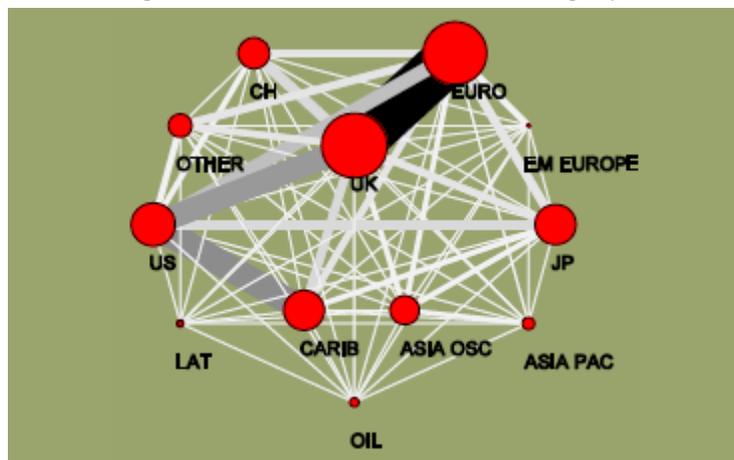
Chart 4



Source – Bank for International Settlements Quarterly Review, June 2008

OFCs Included – Aruba, Bahamas, Bahrain, Barbados, Bermuda, Cayman Islands, Gibraltar, Guernsey, Hong Kong SAR, Isle of Man, Jersey, Lebanon, Macao SAR, Mauritius, Netherlands Antilles, Panama, Samoa, Singapore, Vanuatu, West Indies UK.

FIGURES AND CHARTS (CONT'D)

Chart 5
Linkages in the International Banking System

Explanatory Notes

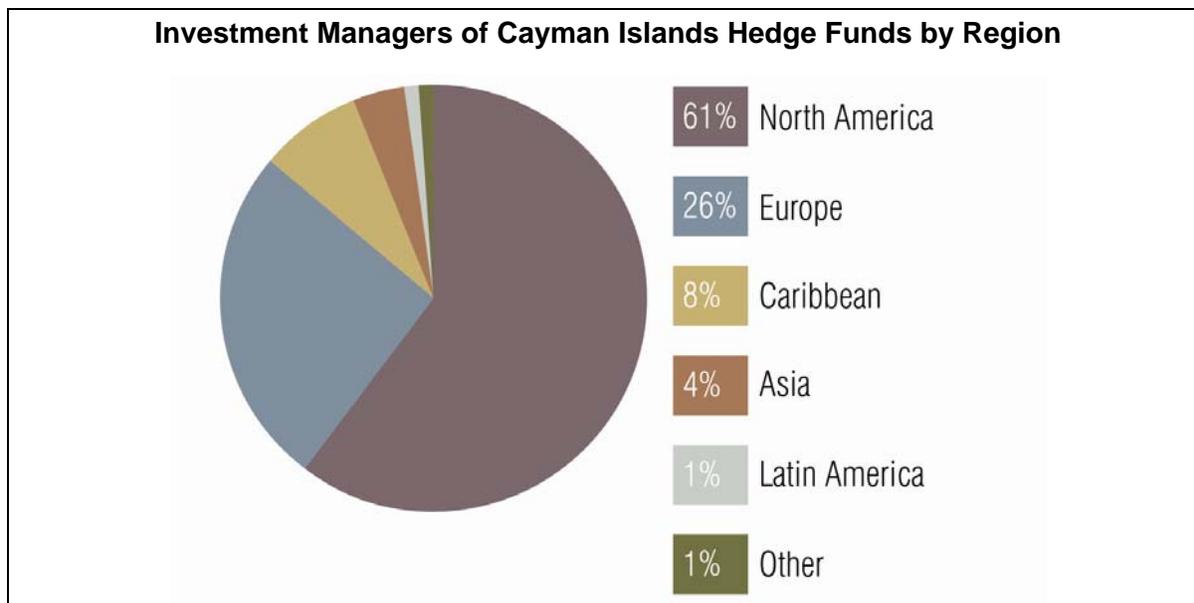
The size of each red circle is proportional to the outstanding stock of cross-border claims of reporting banks located in the particular geographical region. Some regions include countries which do not report data. The thickness of a line between regions A and B is proportional to the sum of claims of banks in A on residents in B and claims of banks in B on residents of A. The size of the circles and thickness of the lines are scaled by the overall stock outstanding, and thus are not directly comparable across panels.

Key to Abbreviations

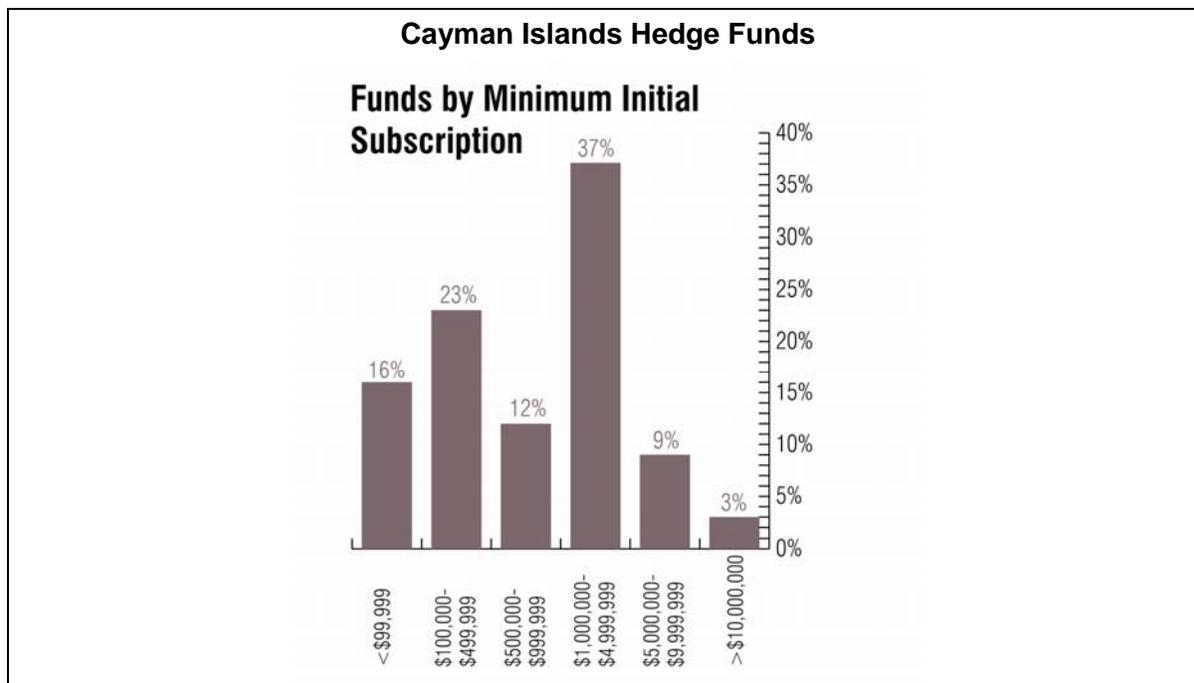
ASIA OSC	Hong Kong SAR, Macao SAR and Singapore
ASIA PAC	China, India, Indonesia, Korea, Malaysia, Pakistan, the Philippines, Taiwan (China), Thailand
CARIB	Aruba, Bahamas, Bermuda, Cayman Islands, Netherlands Antilles, Panama
CH	Switzerland
EM EUROPE	Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia, Turkey, Ukraine
EURO	27 euro-area countries
JP	Japan
LAT	Argentina, Brazil, Chile, Colombia, Mexico, Peru
OIL	OPEC member states (excluding Indonesia) plus Russia
OTHER	Australia, Canada, Denmark, New Zealand, Norway, Sweden
UK	United Kingdom plus Guernsey, Jersey, Isle of Man
US	United States

Source – BIS Working Paper No.244, January 2008

FIGURES AND CHARTS (CONT'D)

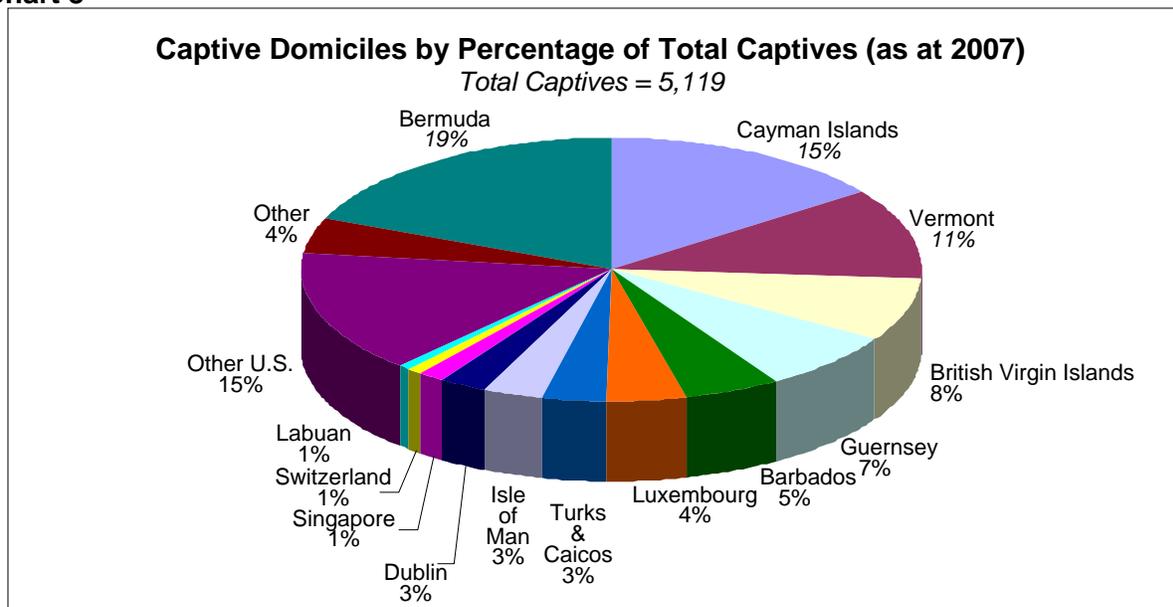
Chart 6

Source – Cayman Islands Monetary Authority

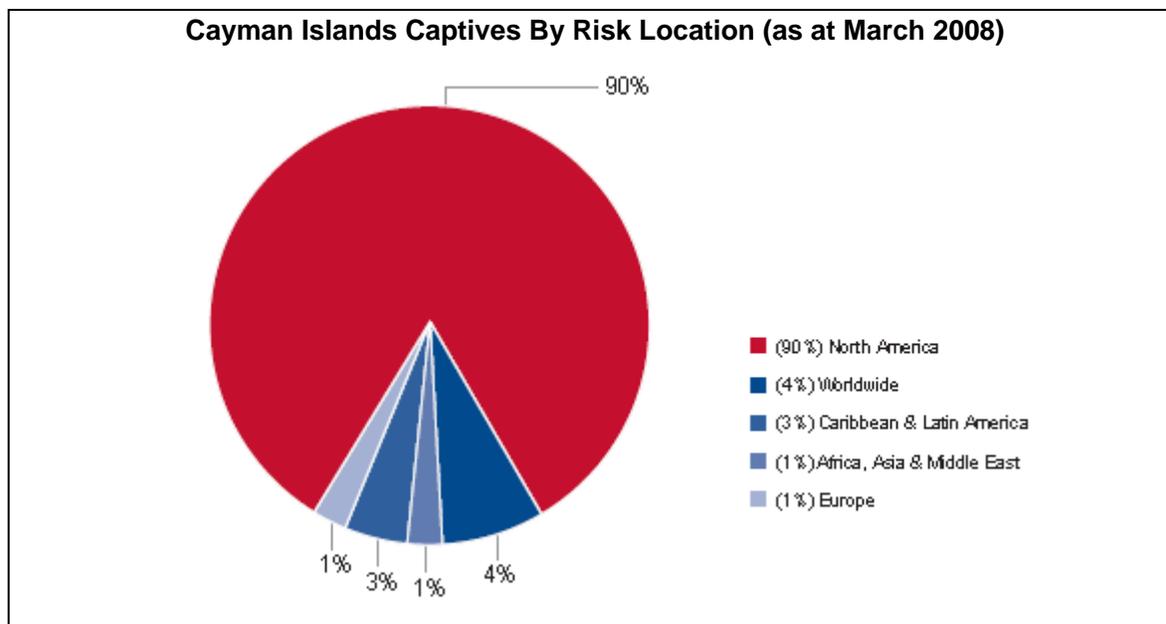
Chart 7

Source – Cayman Islands Monetary Authority

FIGURES AND CHARTS (CONT'D)

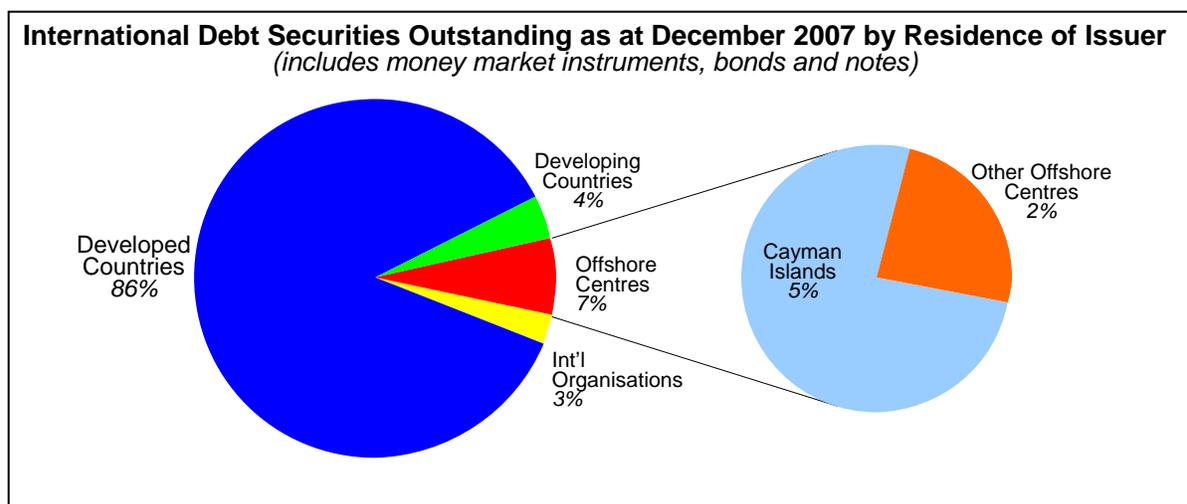
Chart 8

Source – *Business Insurance Magazine* (March 2008)

Chart 9

Source – *Cayman Islands Monetary Authority*

FIGURES AND CHARTS (CONT'D)

Chart 10

Source – Bank for International Settlements Quarterly Review, June 2008

Developed Countries – Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States.

Offshore Centres – Aruba, Bahamas, Bermuda, Cayman Islands, Hong Kong SAR, Lebanon, Netherlands Antilles, Panama, Singapore and West Indies UK.

Developing Countries – *Africa & Middle East:* Israel, Qatar, South Africa, Tunisia, United Arab Emirates – *Asia & Pacific:* China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand – *Europe:* Croatia, Hungary, Poland, Russia, Slovakia, Turkey – *Latin America & Caribbean:* Argentina, Brazil, Chile, Colombia, Mexico, Peru, Uruguay and Venezuela.

FIGURES AND CHARTS (CONT'D)
Chart 11
