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The Regulatory Framework of The Bahamas Financial System and its Appropriateness for International Financial Institutions

Introduction

One measure of financial maturity of any economy is often the regulatory framework on which it rests. No doubt, the Bahamian economy is no exception. In fact, the authorities in The Bahamas have, for a number of years, been steadfast in their efforts to implement a suitable regulatory framework which complements the dynamic domestic and international financial environment.

Moreover, given its prominent offshore financial status, the authorities have had to be mindful in tailoring a framework which on the one hand espouses vigilance, hence protecting the international financial reputation of The Bahamas; yet on the other hand, sufficiently flexible so as to attract rather than constrict the level of offshore business that comes to The Bahamas.

In recent years, Bahamian authorities have not only had to implement new regulations which have been designed to address current financial trends but also consider introducing regulations which will be consistent with the overall future development of the Bahamian financial sector.

The intent of this paper will be to examine the compatibility of the existing regulatory framework with the financial system as well as discuss the various financial regulations which the authorities envisage will be applicable to the financial environment of the 1990's and beyond.

Briefly, there will be five sections to this paper. Section I gives an overview of the legal framework of The Bahamas. Section II provides a historical overview of the development of Bahamian financial regulations. Section III will assess the current state of regulation and its appropriateness. Section IV looks at some of the problems encountered with financial regulations in The Bahamas. Lastly, Section V presents a discussion of various pieces of legislation which are being reviewed and which will ultimately determine the soundness of the financial system.

Section I

Legal Framework

The Bahamas' legal system is patterned after the English common law and legal procedures. In fact, the financial supervisory approach has been modeled after that employed by The Bank of England. Overall, this framework has been generally regarded by the majority of the institutions as an advantage; however, those institutions whose parent companies are domiciled in civil law jurisdictions may have encountered some difficulties.

Provisions applicable to company registration and licensing, although becoming more demanding, are nevertheless still relatively relaxed as against those in some of the more industrialized jurisdictions. On the other hand, there are rigorous bank secrecy laws that the Bahamian government has endeavoured to enforce.

Section II

Historical Overview

Due to the fact that The Bahamas has not been richly endowed with the traditional natural resources and raw materials, emphasis has been concentrated into the full scale development of its service industry. In particular, the development of the financial sector has been

experiencing healthy expansion for a number of years. No doubt, the establishment of suitable regulatory controls has complemented this expansion.

Financial institutions operating in The Bahamas prior to 1965 were regulated under The Bank Act of 1909. However,in light of external and domestic developments, The Act proved inadequate, hence necessitating a change in legislation. Consequently, The Bank and Trust companies Act of 1965 was enacted, and today stands as the principal piece of financial regulation existing in The Bahamas.

The weaknesses in The Bank Act of 1909 became distressingly evident in the early 1960's, as it was during this period that the Eurodollar market emerged. This market featured many U.S. banks transacting a significant amount of their business through their European branches, mainly in London. U.S. banks along with international financiers quickly recognized that in comparison to Europe and the United States, the establishment of branches in The Bahamas was more advantageous, involving no taxation, no control on capital flows, and only minimal regulations.

Consequently, owing to the somewhat laissez-faire licensing system peculiar to The Bank Act of 1909, some 600 entities resembling banks and trust, companies commenced operating in The Bahamas. As it eventually turned out many of these companies were of a dubious nature and suspect character. It became clear to the Bahamian authorities that the Act under which these companies were regulated was grossly

Since that time the number of licenses granted under the Act has registered uninterrupted growth, with roughly 15-20 new licenses granted annually. The current number of licensed institutions totals three hundred and eighty two (382), with over one hundred and twenty (120) having an actual physical presence in The Bahamas.

In short, The Bahamas has had to dismantle one regulatory framework and replace it with another, more appropriate one. This revamping of framework is evidence that the financial world is dynamic, and that the course of regulatory change which has occurred in The Bahamas reflects the tailoring of a regulatory system which must on the one hand be cognizant of the impulses of orderly growth while on the other hand blend the proper mixture of prudence, cost effectiveness, flexibility and integrity.

Section III

Current State of Regulations and Appropriateness

As highlighted in Section I, the existing financial regulatory controls and policies of The Bahamas are in large measure embodied in The Banks and Trust Companies Regulation Act of 1965, the active enforcement of which is conducted by the Bank Supervision Department of The Central Bank of The Bahamas.

The underlying spirit of the regulatory framework is one which aims at developing a financial environment which is conducive to

business growth, free from cumbersome regulatory controls and which does not compromise the commitment to honesty and professionalism.

Each bank and trust company incorporated in The Bahamas is required to be registered with The Registrar General, as stipulated under The Companies Act of 1866 (as amended), and must file with the Registrar a Memorandum and Articles of Association and an annual return, along with paying stamp tax on the issuance of shares and an annual franchise fee. Also, under the Bank Act of 1909 and the Bank and Trust Companies Regulation Act of 1965 (as amended) no banking or trust business is permitted to be carried on from The Bahamas without a license granted by the Minister of Finance.

Licensees are further obliged to have a principal office and an agent/deputy agent in The Bahamas.

The policy of the financial authorities has been to favour the issue of licenses to only those branches or subsidiaries of leading, reputable international jurisdictions. This particular policy is indicative of The Bahamas' support of the concordat, which represents the Agreement among Central Banks on guidelines for supervision, recognizing that the ultimate responsibility for the institution's operations lies with the parent company.

On an annual basis a system has been adopted to undertake a thorough and critical appraisal of the condition of each licensee. This system includes preventive analysis of balance sheets and income

statements and the review of relevant expanded data/statements obtained in specific cases. Positions with respect to liquidity, solvency, large exposures (including cross border exposure) and profitability are carefully examined. Mindful of the particular norms which have been established in this regard, the primary purpose of these analytical exercises is to send a signal which will alert the authorities of any institution(s) that deserves closer scruntiny.

Connected to this system of annual appraisals is the holding of prudential discussions with licensees. Focus is often attached to those cases where unfavourable aspects or trends about the financial position of an institution are revealed through the examination of balance sheets. These discussions also involve the evaluation of internal controls and risk management.

External audits and reports by firms approved by The Central Bank are important to the execution of proper financial regulation. Also, the auditors are involved in discussions whenever regarded as necessary.

With respect to regulating the quality of management and ownership of the financial institutions, The Central Bank will only grant approval to those individuals of rectitude and honesty. Unethical behavior is punished, as various cases can be cited where General Managers and Chief Executive Officers of banks were removed at the insistence of The Central Bank. Also, share transfers of institutions are not allowed unless The Central Bank grants approval.

Finally, numerous and misleading name changes are prohibited, and institutions are forbidden to bear names that might suggest connections with other firms with which they have no connection.

Every bank licensee is required to publish its balance sheet in the Official Gazette within four months of the end of its fiscal year. For branches, the financial statements of the parent bank are considered adequate; whereas locally incorporated banks must present their own statements, audited by a reputable accounting firm conducting business in The Bahamas.

A position has been taken by The Central Bank that all unrestricted licensees should, in the initial phase, maintain a minimal capital of $1 million or a capital ratio of 3% of total assets, whichever is greater. This quantitative method has been adopted mainly because it represents a public disciplinary system, obliging the institution to sustain their "own" resources at an acceptable level. Further, the Board of Directors must be either professional businessmen/or bankers possessing a staff of competent technicians and administrators.

Forming a part of the regulatory system is the level of fees charged. Similar to the capital standards, fees are kept high so as to operate as a deterent to block fringe companies and malcontents from entering the financial system. Annual fees range from a high of $160,000 for an "authorized agents and authorized dealers "licence to a low of $1,000 for a "non-active" license.

There is also frequent dialogue with other international supervisory agencies for the exchange of information concerning prospective clients and financial institutions.

For the most part, the somewhat liberal framework operating in The Bahamas has been compatible in facilitating the orderly development of the financial system, as the growth in the number of institutions operating in The Bahamas has been steady, attracting many of the leading institutions whose parentage are located in some of the other properly regulated jurisdictions worldwide. In addition, the authorities have progressively sought to review and enhance the framework. Collectively these efforts have cultivated The Bahamas' position as a prominent international financial centre whose objective is to encourage prudent and healthy financial practices.

However it is evident that there are some criticisms of the framework which tend to diminish the extent of regulatory suitibility. For instance, in light of the proliferation of the drug trade and the extensive exploitation of the banking system for the purpose of money laundering, the secrecy regulations of The Bahamas have been the object of sharp criticism and are being challenged on the grounds of inappropriateness.

Law enforcement authorities throughout the world, (in particular those from the United States), in their pursuit of alleged drug traffickers and other criminals, have aggressively attempted to

penetrate Bahamian secrecy laws, insisting that these laws facilitate the perpetration of criminal actions through the banking channels. U.S. authorities vehemently argue that Bahamian secrecy laws are inadequate and should be amended to include provisions which will require banks and financial institutions to report or record transactions in foreign currency or domestic currency or the international transportation of such currency refers. It is believed by U.S. authorities that the inclusion of such a clause (outlined in The Kerry Amendment, 1988) provides greater access to information and accordingly significantly assists in the prevention and elimination of the illegal trade in narcotics and drugs.

Due to the fact that the Bahamas is a major international Euro-money centre which relies heavily upon its commitments to secrecy, there is no existing law which requires or authorizes the Central Bank to require banks or financial institutions to report or record transactions in foreign or domestic currency. However, The Central Bank, through powers vested in omnibus clause Section 33 (1) of The Banks and Trust Regulation Act of 1965 may require any financial institution or trust company or any director, officer or servant of such an institution to supply to The Bank such information as The Bank considers necessary to enable The Bank to carry out its function under this Act. Provided that information regarding any deposit made by any individual with any such institution or company may not be required by The Bank by virtue of the provisions of this Section. Granted this, the Central Bank has abstained from calling for information in respect of individual accounts.

Although the Bahamas has no intention of compromising its position regarding rigid support of its secrecy laws, by the same token, The Bahamas, via the passing of the 1986 Drug law which is designed to trace and forfeit the proceeds of drug trafficking, coupled with the Code of Conduct of the Association of International Banks and Trust Companies of The Bahamas, has indicated resistance to the use of its territories or banking system for criminal purposes.

Moreover, concerted efforts between officials from The Bahamas and The United States has produced a major initiative which has been agreed upon in principle, this being the Mutual Legal Assistance Treaty (MLAT). In effect, the MLAT provides for the exchange of information where serious offences, such as drug trafficking and theft are recognized by both governments as having been committed. In short, the MLAT, the Drug Law of 1986 and the self regulation Code of Conduct are all indicative of the fact The Bahamas' regulatory framework has been sufficiently flexible to address problems which might undermine the entire viability of the framework itself.

Another point of concern is the question of conducting on-site inspections without violating secrecy provisions. Presently, there are no on-site inspections of banks. In fact, the Bank and Trust Companies Regulation Act does not establish specific auditing requirements as is the procedure in many other foreign countries. Instead, under the Act each bank is obliged to publish true and exact annual financial statements which must be certified by the Bank's

auditors. The Central Bank has insisted that each bank and trust company select an auditing firm from a list of auditing firms approved by The Central Bank.

However, The Central Bank has limited powers which enable it to discuss with the auditors the financial situation of an institution without infringing upon the principle of confidentiality. For example, cognizant of the need for strict secrecy concerning the business of the trust companies, The Central Bank has refrained from seeking detailed information on the trust accounts of trust companies. Instead emphasis has been given to examining the adequacy of the procedures and internal control of trust companies, ensuring that the companies are operating in accordance with the law and are not participating in affairs which are forbidden under the terms of their respective licence. Therefore, the scope for obtaining comprehensive data on financial institutions is constrained by recognition of the right to confidentiality and secrecy.

Under the existing framework, the direct control over the supervision of management companies in The Bahamas is for the most part nonexistent. Thus, a certain degree of control may be exercised by the Central Bank. That is, in order to operate in The Bahamas the management companies require foreign currency accounts which need Exchange Control authorization. Prior to authorizing such accounts The Exchange Control Department liases with the Bank Supervision Department, which in turn scrutinizes the activities of the companies. It is only after the Bank Supervision Department is

appeased with the conduct of the companies operations that foreign currency accounts are authorized.

Section IV

Difficulties Associated with the Financial Regulatory Framework

No doubt the existing financial regulatory framework is not immune from its share of problems. In fact, the difficulties which have surfaced are varied and clearly highlight the weaknesses inherent in the regulatory structure. Moreover, these difficulties have been largely responsible for minimising the extent of regulatory control at the disposal of the authorities.

Oddly enough and even ironic is that one of the main impediments of the "liberalized" regulatory framework is the rigidity involved with compamy formation. In comparison to competing offshore financial centres such as: Panama, The Cayman Islands and the British Virgin Islands, the legislation pertaining to company formation in The Bahamas can be classified in some instances as archaic, almost out of place in the modern financial world. Currently, the legislation does not provide for company mergers, consolidations and non-profit organizations; nor does it allow for the use of electronic media, such as teleconferencing for Board of Directors meetings. In addition, company laws dictate that those individuals seeking to set up operations and thus take advantage of the Bahamas' offshore financial climate are required to have five directors; also, directors meetings

are required to have a physical presence. Furthermore, there are no provisions for bearer shares, neither is there any exchange control exemption for companies not conducting business with persons resident in The Bahamas. Finally, the length of time in which a company can be incorporated in The Bahamas, seven days, can be regarded as excessive, especially when considering the fact that incorporation in competing centres, for example, Turks and Caicos, is less than one day. These features outlined point to some of the stifling elements existing in the fabric of the framework, which tend to curb offshore financial growth.

Still another difficulty concerns the absence of any regulations which safeguard international money and trust managers from the attacks of other jurisdictions. Specifically with regards to trust operations in The Bahamas, there is no legislation which declares the jurisdictions in which settlements can occur; as a result, the authorities from other countries, in particular those countries which do not recognize the concept of trusts, have the capacity to challenge the validity of trusts established in The Bahamas.

Owing to the fact that there is no regulation requiring that the offshore financial institutions keep their financial books and records in The Bahamas, the ability of the regulators to obtain timely information is constrained. What often occurs is that, in order to receive necessary financial records the authorities incur delays as the information is forwarded from locations outside The Bahamas; such

delays therefore limit the capacity of conducting timely financial analysis.

The scope of the regulators in assessing the performance of offshore managers regarding asset management coupled with determining the financial soundness of the entity is limited, as the audited financial statements do not, and are not required to provide comprehensive disclosure of information. In short, there is a need to improve the working relations between the auditors and the financial authorities so as to encourage greater information disclosure. Currently, the BASLE Committee in collaboration with the International Accounting Standards Committee are reviewing this problem with a view of making appropriate recommendations.

A significant deficiency in the framework concerns the absence of winding-up powers. That is, despite possessing the power to revoke licenses, winding up powers however are not available to the authorities. Winding up capability is important to regulators so as to ensure that the depositors and creditors of the offshore institution are afforded a measure of equity and fairness when assets are being liquidated. As it stands now, even after a licence has been revoked this does not mean that the institution has been properly wound-up; moreover, there is no guarantee that fairness in meeting the

claims of creditors or protecting the liabilities of depositors will be forthcoming from the institution.

In the context of the domesting banking environment, those banks which violate their liquid asset ratios (LAR) as stipulated by The Central Bank, are not liable to any form of regulatory penalty. Rather, in order to impose penalities upon such violators the courts must be brought in which is likely to be cumbersome involving considerable resources and time. Of course only domestic banks are required to maintain specified LAR positions.

Fine-Tuning of the Framework

Cognizant of the various shortcomings of the regulatory structure, which have become more glaring in light of the modern framework existing in many of the competing offshore financial centres, The Bahamas has had to review and accordingly refine its regulatory legislation. The decision to implement refinements has been further spurred by the growing level of money laundering activity which has infiltrated the banking channels of numerous offshore centres, including The Bahamas, and has consequently tarnished the image or offshore banking in The Bahamas.

Initiated in 1985, The Association of International Banks and

Trusts in The Bahamas in cooperation with The Central Bank of The Bahamas, created an explicit Code of Conduct. The principal intentions of the Code were three-fold: (a) maintain and enhance the reputation of The Bahamas as an international financial centre; (b) prevent the use of banks and trust companies in The Bahamas for illegal purposes; and (c) to abide by the principle of banking confidentiality/ secrecy as embodied in Bahamian legislation.

Overall, the code is believed to have represented an effective step towards stemming the flow of large cash transactions linked to illegal activities, such as drug smuggling. Moreover, it represents an indication of financial maturity designed towards enhancing the overall image of offshore banking in The Bahamas and promoting legitimate financial business. The code in fact forms the basis for codes in several other offshore havens which have had to address similiar circumstances.

More recently, the Bahamas Government has introduced a package of new financial legislation aimed at both advancing as well as bolstering the regulatory environment. Briefly, there is the proposed new Companies Act and The International Business Companies Act. The Companies Act seeks to lay down the requisite provisions for company mergers, consolidations and non-profit entities. Furthermore, it allows for the use of electronic media, such as teleconferences, so as to facilitate Board of Directors meetings. Similarly, the

International Business Companies Act provides for teleconferencing, as well as permitting a board of directors with a minimum of two rather than the usual five members. Also, the annual fee for non-resident companies is to be reduced, with the company exempt from all Bahamian duties, taxes and Exchange Control Regulations. Provisions have also been drafted for liquidation by the company of its own capital and transferability to any jurisidiction that can accept a transferred company. The time in which incorporation can be completed is anticipated to be reduced from the current seven days to within twenty-four hours.

The business of Trusts is also to be fine - tuned, as regulations have been drafted which will make the establishment of a trust in The Bahamas conducive to residents of many civil law countries which do not recognize the common law concept of a trust. Thus, an individual seeking to create trusts in respect of property will now be able to select laws of The Bahamas as the governing laws irrespective of the location of the actual property.

There has also been a review of the regulatory core applicable to the insurance business, with the major thrust directed towards revitalizing the captive international insurance business.

The main laws governing the industry are the Insurance Act 1969 and the External Insurance Act 1983. The focus of this review has been to offer international investors a more accomodative framework, free from constricting legal rules and regulations.

Conclusion

In summary, the regulatory framework has to a large extent proven itself to be suitable in terms of satisfying the demands placed upon it by a dynamic financial environment. Moreover, in those instances when modernization has been necessary, the framework has been sufficiently flexible to incorporate change with only minimal disruption effected upon the financial system. Lastly, the authorities have recognized the weaknesses in the regulatory code and have accordingly undertaken efforts which will be in line with the unfolding of the Bahamian financial community.