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REGULATION AND FINANCIAL SERVICES DEVELOPMENT IN THE ECCB AREA

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Regulation and Financial Services Development in the ECCB Area

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Introduction

The Offshore Financial Services Sector in the ECCB member countries is characterised by varying degrees of development, ranging from Antigua and Barbuda where it has been in existence since 1982, to Dominica where the ink is hardly dry on the legislation. In the past, countries have carved out niches, some of which have been developed but most have not been exploited for their true potential, mainly a result of the lack of systematic programmes for their development. Except for Antigua and Barbuda and more recently Anguilla, Offshore Financial Services have been a little more than a curious sideline activity for most of the countries. However, as the prospects for the export of traditional agricultural products have dimmed, renewed interest has been placed on financial services development for export replacement and the creation of skilled jobs. In recent months, all of the ECCB countries have either passed new legislation or re-examined the existing legislation which enables the development of off shore financial services. One worrying trend is the tendency for the countries within the currency union to compete with each other on the incentives offered in the legislation. Since none of the ECCB member countries are able to offer the level of ancillary service necessary to compete with established destinations, they have opted to craft legislation which provide unique incentives to the prospective offshore enterprises.

This development raises questions about the ability of the regulatory authorities in the individual countries to adequately police the industry, since the ECCB Agreement does not extend to Offshore Financial Services. The regulation and supervision of the financial sector is the joint responsibility of the ECCB and the Ministries of Finance in the respective countries, which constitute the Monetary Authorities. Some aspects are exclusively the ECCB, others are the exclusive preserve of the Ministries of Finance and yet others are jointly regulated. Offshore Financial Services is the exclusive responsibility of the Ministries of Finance, however some of the Ministries of Finance have opted to use the ECCB in a advisory capacity. This

arrangement is fraught with danger given the limited regulatory capability in the individual Ministries of Finance. Indeed, in some islands the offshore services office is staffed by one or two persons.

A second issue which arises from the unplanned development of the financial services sector is the creation of a dual financial system with the offshore sector, modern and sophisticated and the domestic financial sector lagging behind. This enclave type development would limit the contribution of the Offshore Financial Services sector to the overall development of the economies, since it would not be able to exploit the potential synergies which exist, nor would the economies be able to adequately provide the ancillary services and professionals necessary for the development of the offshore sector.

The rest of the paper focusses attention on these two issues and is organised as follows: Section I of the paper would look at the theoretical issues in the regulation of financial institutions as they pertain to the development of financial centres and discusses the issue of international regulatory arbitrage. Section II would discuss the state of the financial services sector in the ECCB area and comment on its likely evolution if the current situation continues. Section III will present an alternative path for the development of the sector and the final section would give some concluding comments.

The Theory of Regulation

The regulation of providers of financial services has a long and checkered history, with financial institutions being subject to some kind of government control from the earliest times. Even during the "free banking" era, the concerns of safety, stability and structure were addressed by rules established by the authorities. Entry was largely free as charters were granted to bankers who met certain minimum requirements, safety was addressed by the requirement to post collateral against their outstanding circulation and stability was maintained by the rules of the gold standard. Every country has its peculiar regulatory system which is

derived from it historical experiences, its social and political milieu which determines what is practical and possible in that country.

Historically, nine reasons have been advanced for the regulation of financial institutions (Bentson [1983]). These may be divided into three broad groups:

(a) Protection of the Financial System Against Systemic Risks

Historically, this has been the overriding reason for the regulation of the financial markets and financial institutions. The threat of a contagious spread of failure across financial institutions, which may result in a sharp and prolonged reduction in real output, has not been taken lightly. The process may begin with losses in one sector of the financial system resulting in the failure of one or more large institutions. These failures can in turn generate a crisis in the core banking and payments system. The consequent credit shocks may have significant harmful effects on the economy. It is for this reason that many countries in recent years have imposed enormous burdens on their tax payers to bail out failing financial institutions in order to stabilise the financial system[1]. The main regulatory activities to avoid systemic risks are:

The Maintenance of Safety and Soundness, which would avoid bank failures and the consequent negative effects on the economy.

The Protection of Some Suppliers of Financial Services From Competition. Any regulatory system is the result of political decisions which balance the interests of different types of suppliers, consumers and the regulatory authorities themselves. Thus, in order to protect the interests of some financial services suppliers, regulatory changes are frequently enacted.

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[1] In recent years the USA, Sweden, Japan, Venezuela, Mexico and Argentina have spent enormous amounts of money to clean up the financial system.

(b) Consumer Protection

A second objective of financial regulation is the protection of the consumer against excessive prices or opportunistic behaviour by participants in the financial markets. The regulatory activities pertinent to this area are:

The Prevention of Centralisation of Power, through Anti-trust laws and the control of mergers.

The Prevention of Invidious Discrimination and Unfair Practices. Discrimination against minorities and Truth in Lending practices fall under this heading.

The Protection of Deposit Insurance Funds, where they exist is another rationale for the regulatory system. Although deposit insurance may reduce the level of regulatory presence, it requires some amount of regulation to maintain the integrity of the Funds.

(c) The Achievement of Social Objectives

Due to the critical role that the financial system plays in economic activity, the authorities in most countries have tried to regulate the financial system in a way to achieve certain economic goals. In many developing countries, the regulation of the financial system has been used as an integral part of their development strategy, sometimes with disastrous effect. The major activities in this area include:

The Provision of Financial Services as a Social Goal. Some countries have regulations in place to ensure that some elements of the society receive financial services at reasonable prices.

The Allocation of Credit as a Social Goal. This is especially in the area of housing, but other credit allocation to sectors deemed necessary for the development of the economy falls under this general heading.

The Taxation of Banks as Monopoly Suppliers of Money. This is done either directly through taxation or indirectly via the maintenance of non-interest bearing required reserves.

Control of the Money Supply. The conduct of monetary policy requires some regulatory support in order to be effective. The required reserve ratio is the major regulatory instrument used here.

The desirability and efectiveness of many of these objectives of regulation are widely questioned in today's neo-liberalist environment. It is sometimes argued that the only rationale for the regulation of financial institutions is the avoidance of systemic risks. Although the presence of Central Banks as lenders of last resort and the existence deposit insurance can virtually eliminate systemic risks, it creates a moral hazard for financial institutions to take risks at the expense of the government and tax payers who finance these schemes. Hence the need for a properly functioning regulatory framework to avoid this danger. In this context, the safety and soundness of the financial system can be seen as a public good, and even if some amount of self regulation will be provided by the financial institutions, it would not be optimal, hence the need for governmental regulation and supervision.

Regulation of Offshore Financial Services

The same concerns which motivate the regulation of the domestic financial system are also present at the international level, but with a further complication. While domestic financial institutions are generally unable to move between jurisdictions to avoid regulatory restrictions on their activities, financial institutions can and do engage in international regulatory arbitrage. The removal of capital controls and major advances in communications make this possible.

Consequently, jurisdiction which impose excessive burdens of regulations would find that financial institutions would simply go to less restrictive, cheaper jurisdictions to avoid the costly and time consuming compliance with burdensome regulations. Offshore financial centres provide avenues to legally avoid stringent and onerous regulations. In addition, they provide opportunities for financial institutions to diversify into business activities not permitted at home, thus leveling the playing field for them to compete with foreign competitors who are not so constrained by domestic regulations. Thus the development of offshore financial centres was spawned by the increased practice of regulatory arbitrage.

However, there are limits to which nations can and will engage in regulatory laxity to compete for foreign financial institutions (Herring & Litan [1995]). They argue that reputable users of financial services will not choose to deal with financial institutions or markets in countries with excessively lax regulations, imperfect legal systems and poor communication and transportation facilities. After all, they would not want their reputations to be sullied by financial dealings in questionable offshore jurisdictions. On the other hand irreputable institutions would find laxity quite attractive.

The concept of systemic risks applies with equal force at the international level as it does at the domestic level. Given the consummate ease with which funds can be moved internationally, crises in the financial sector in one country can be easily transmitted to other countries with a contagion effect throughout the international financial system. For example, the failure of the parent company in one country will affect its subsidiaries in other countries. Similarly, failure of subsidiaries may affect the parent company. Small countries like those in the Eastern Caribbean cannot have systemic impact at the international level. However, the failure of firms in their offshore financial sector or scandals associated with fraudulent activities may have contagious effects on the rest of the firms in the financial sector of that particular country and the rest of the currency area. It is in this sense that lax regulatory practices pose a systemic risk to the ECCB sub-region and the Caribbean area in general.

Similarly, the protection of the international clientele of the firms in the offshore sector from fraudulent activities must also be a preoccupation of the regulatory authorities. In general, the protection of consumers does not have international spillover effects, since residents of different countries have divergent preferences for protection. However, differences in the cost of disclosure standards and the cost of financing deposit insurance schemes may have some spillover effects on international markets.

Regulations which are applied to achieve social objectives like credit allocation to favoured sectors, the control of monopoly and political power and to inhibit illegal activities such as drug trafficking and money laundering, which may be conducted through the financial system, can and do have international externalities. The first two are analogous to cross border imposts on international trade in goods and have been the subject of negotiations under the General Agreement on Trade in Services (GATS) in the Uruguay Round of trade negotiations.

Types of Offshore Financial Services

It is estimated that as much as 60 per cent of the world's money resides in about 40 low-tax or zero-tax offshore finance centres (Offshore 95). This is to say that trillions of dollars flow through offshore financial centres. Global economic expansion has created increased economic wealth and has broadened the scope of corporate operations and expansion. In major investment portfolios of corporate structures, an offshore component is increasingly apparent. The growing use of offshore financial services reflects the investors' desire to minimize taxes, diversify and protect assets, spread risks and engage in regulatory arbitrage. The offshore sector provides flexibility in international business, less regulation and lower costs of doing business compared to "on-shore" financial institutions around the world.

By definition, offshore financial institutions conduct business with persons and entities not resident in the jurisdiction in which the offshore institution is registered or incorporated. Within the ECCB Area, most of the offshore legislation prohibits the conduct of business in any

CARICOM currency. The financial services sector potentially can provide large value added. It requires an educated and professional work force, and is not capital intensive. The offshore financial industry is increasingly competitive, consisting of major established centres such as Bermuda, Channel Islands, Cayman Islands, Guernsey, Ireland, some Pacific and Asian locations, and the emerging Eastern Caribbean islands. The most successful offshore centres are said to be those which levy lower or no taxes on investors; offer mitigated cost of operations, possess strong confidentiality and secrecy laws, are well regulated with up-to-date laws and a wide range of professional ancillary services.

Six types of offshore financial services are offered in the OECS countries, viz. International Business Companies, Offshore Banking, Captive Insurance, Trusts, Limited Liability Companies and Mutual Funds. Each has its own characteristics and are briefly described below.

International Business Companies

The international Business Company (IBC) is the most popular vehicle for the delivery of offshore financial services. It is usually implemented either as a zero tax destination or a low tax destination in conjunction with tax sparing treaties with one or more developed countries. The IBC in a low tax destination is usually implemented as part of a larger tax planning strategy. This form is usually associated with double taxation treaties with the countries which serve as the home base for these corporations. In zero tax regime, the IBC operates as a holding company which can be used several tiers deep to mask the true ownership of enterprises. The zero tax variety is of doubtful efficacy, since without the paper trail and reporting requirements associated with the payment of tax, they are open to abuse for illicit activities. Unlike banking and insurance companies, they are not licensed companies and are not required to submit annual returns. The issuance of a certificate of registration is sufficient for the commencement of business, which can be conducted in a cloak of anonymity, since it is not subject to periodic audit or ongoing surveillance. The only backup in this case to thwart attempts at illegal activity is the efficacy of the procedures in place in the banking system to deter such activities. While

most OECS destinations have in place countervailing measures in the form of proceeds of crime legislation and guidelines to prevent money laundering, the existence of zero tax regimes for IBC's is an unnecessary temptation to the less scrupulous members of the international financial community. The important issue here is that the risks associated with an IBC used outside of a tax planning disclosure arrangement may vastly exceed the benefits from this financial services product in an emerging under-regulated financial centre.

Most of the IBC's in the ECCB area have been modelled on legislation in the BVI and other tax free jurisdictions. Typically, these IBC's are exempt from all forms of taxes in the jurisdiction of their incorporation; these include income taxes, corporate taxes, capital gains tax, inheritance tax, withholding tax, or other direct taxes levied in respect of international business activity. The IBC's are also exempt from indirect taxes such as stamp and customs duties.

Offshore Banking

Offshore banking refers to the acceptance of foreign currency deposits; sale or placement of bonds and other securities denominated in foreign currency; and other activities including foreign currencies or securities. In some jurisdictions, there is an explicit prohibition of such activities between the institution and residents of the host country. The establishment of offshore banking facilities requires strict regulatory attention at the licensing stage and ongoing surveillance of the licensed institutions. Both of these require persons who are equipped with the requisite banking, legal and accounting skills to effectively regulate the industry. At the licensing stage, application for a license requires careful scrutiny of the proposed articles of incorporation, the proposed business plan, pro forma financial statements, the corporate structure of the institution, profiles of the principals of the bank, financial statements of the persons who will operate the bank and the shareholders, arrangements which exist for the issuance of shares, voting and other matters related to the management of the institution. This initial stage is critical since an effective job at this stage would weed out most of the institutions disposed to fraudulent activities, and considerably lighten the load at the second stage.

The second stage of regulatory activity involves the continuing surveillance of the licensed institutions. This would require careful examination of periodic returns and balance sheet and income statements. Periodic audit and inspection would also confirm compliance with all of the laws governing the operation of the institution.

Carmichael et al (1996) assert that "Offshore Banking therefore requires a regulatory authority which is modern, adept and conversant with all of the latest developments within the financial services and international banking world". Such expertise may be outside the capabilities of most individual OECS jurisdictions.

Offshore Trusts

Several of the islands have introduced new Trusts laws, while others such as Antigua & Barbuda regulate Trusts within the general IBC Act. A trust does not need to be owned by anybody, but a company does. In theory therefore, the trusts owns the assets, and while a trust is still liable to pay tax and other charges, it pays them in accordance with the rules of the jurisdiction in which it is located, thereby offering protection to the underlying assets. Trusts are used to provide asset protection, to protect family wealth from confiscatory taxes, volatile economies and even spendthrift children.

The phenomenal increase in personal wealth, which has resulted in recent years due to the liberalisation of domestic economic activities in most countries, particularly in Latin America and Eastern Europe, has increased the demand for offshore trusts as a financial product. Moreover, Latin American civil law with its concept of forced heirship allows statute to determine who will inherit the estate. The common law concept of trusts established in offshore centres allows the estate owners to settle their estates as they wish, while they are still alive and avoid the extremely high succession taxes which apply.

The offshore trust legislation in Nevis tries to exploit this market niche by exempting trust companies from taxes but charges a modest annual registration fee. The infrastructure and

support services requirements are rather modest and the requisite trust management skills can be brought in.

Limited Liability Companies (LLC)

Limited Liability Companies are hybrid institutions with a corporate personality, but also having some characteristics of a partnership. LLC's provide the benefit of limited liability, but are considered as pass entities for US income tax purposes, so that income and gains are attributable directly to members of the company. Limited Liability Companies are commonly used in joint ventures, venture capital formation and real estate syndications.

The Bahamas, Cayman Islands, Nevis and Anguilla are among Caribbean jurisdictions which have specific legislation for LLC's. The offshore LLC is now used either on its own or combined with offshore trusts to reduce gift and estate taxes and stronger asset protection than is possible to be achieved within the domestic corporate structure.

Offshore Mutual Funds

The mutual funds industry is one of the fastest growing areas in the international financial arena, with numerous open or closed end funds providing professional management of equity to small savers. The growth of mutual funds is partly responsible for the participation rate in financial markets in the USA, moving from 2 per cent in 1975 to 15 per cent in 1995. The most aggressive offshore Mutual Funds Financial centre is Ireland, which currently has over 30 UK companies managing over 100 funds with total capitalisation of US$2 billion.

The OECS countries are considering legislation to facilitate the development of this financial product. The success of this product would require companies legislation which allow for corporate mobility, exemption from exchange control and free convertibility into any

currency. In addition, speedy incorporation of companies would be essential and supporting infrastructure and skills base as in the case of offshore banking.

Captive Insurance

A captive in principal is an subsidiary set up to insure the parent company or a particular project. It is estimated that about forty-four per cent of Fortune 500 companies have captive insurance. Captives receive premiums from the parent which they reinsure in the global market to build up reserves and do away with the need for reinsurance. A captive is a cost effective way to underwrite the risks of the parent and to underwrite multiple risks, or to reinsure principal risks. Major niche players are Bermuda, Cayman Islands, Guernsey and Barbados.

It takes some time to build a reputation, and accumulate the required expertise found in the captive insurance industry. About one-third of captives are health care related (primarily found in Caymans). Captives help to reduce a corporation's outgoing insurance expense, reduce dependability on volatile insurance markets, are less expensive, more flexible and more innovative in their approach to client's risks and needs. Captives also facilitate business enhancement in several ways: captives allow the parent company to provide tailored insurance companies to their customer base, thereby adding customer value and resulting in strategically competitive advantages.

In the case of captive insurance, both the risks and premiums are attributable to sources outside of the particular jurisdiction. Thus, the legislation in the OECS countries treats with the formation, licensing and regulation of the industry. It generally provides the captive insurance companies with exemption from regular taxation. None of the shares are generally owned by residents of the countries. In most jurisdictions, the enabling legislation is the IBC legislation, but Anguilla has specific legislation for Captive Insurance.

Offshore insurance, like offshore Banking, requires careful regulation at both the application/licensing stage and at the level of continuing surveillance. If anything, the regulation

of offshore insurance may require more specialised skills than offshore banking, since it requires insurance regulatory skills in addition to the basic finance skills. At the application stage, regulators would be required to scrutinise detailed insurance business plans, pro forma financial statements which should include estimates of gross and net premium income as well as proposed sources of business. The regulators should be sufficiently familiar with the industry to spot fraudulent applications or applicants who have over-ambitious expectations of the industry.

The degree of basic financial infrastructure and support services is rather more demanding for captive insurance than for offshore banking, which have the option to operate passively as shell institutions for registration purposes, only with the real activity taking place at another destination. The active nature of the captive insurance industry requires supporting banking services, which can provide cost efficient telegraphic transfer services and letters of credit. The required skills base would include insurance accounting, actuarial and claims adjustment skills, which are in short supply in the OECS countries since the insurance industry is entirely agency based.

Carmichael et al (1996) assert that ".. in the absence of such infrastructural capacity within a particular jurisdiction, captive insurance will not develop in spite of the available legislation". They further contend that while the lack of infrastructure would inhibit the orderly growth of offshore banking, it would stunt the growth of a captive insurance industry. In these circumstances, the development of a viable captive insurance and offshore banking sector may turn on the ability of the countries to forge intra-jurisdictional cooperation and strategic alliances.

Structure of The Offshore Industry in the ECCB Countries

ANGUILLA

Anguilla is listed among the newly emerging Offshore Financial Centres. With the support of the British Government, the authorities in Anguilla are making a determined effort to develop the island as a major offshore centre. Anguilla is a zero tax jurisdiction and is rather unique, in that, both its offshore and domestic sectors are not subject to income tax, corporation tax, or exchange controls. Ordinary companies can be used in the same way as an IBC due to the island's zero tax status.

In 1995, the island introduced a package of financial legislation consisting of eight separate ordinances viz: Companies, International Business Companies, Limited Liability Companies, Partnerships, Limited Partnerships, Trusts, Fraudulent Dispositions and Company Managers. Anguilla has also enacted legislation in the area of captive insurance and a Boats and Ships Registration Act.

The island is one of the few jurisdictions which has legislation devoted exclusively to LLC's. Licensing of offshore banks is strictly regulated and is extended only to banks which are subsidiaries or branches of banks with established track records, and which are subject to the consolidated supervision of their home supervisor. Anguilla's new Trusts Ordinance seeks to provide a modern and flexible framework for Trusts practitioners to work with and is intended to stir interest among offshore investors.

Anguilla's IBC Ordinance is said to be modelled on legislation similar to the BVI and the Bahamas. In addition to the zero tax status, the other features commonly associated with IBC's are similar to those discussed in (Darius and Williams [1996]).

ANTIGUA AND BARBUDA

In Antigua four types of offshore institutions are legislated for under the umbrella of the International Business Act 1982. These are General IBC'S, Offshore banks, Insurance and Trusts.

General IBC'S - Antigua's IBCs number about 7000. There is no requirement for paid in capital for a general IBC. The tax exemption features of IBC's in Antigua are similar to those presented in Anguilla. In the case of Antigua however, the tax free period for Antiguan offshore companies is 50 years. The incorporation of an IBC in Antigua can be effected in a few days after application. Antigua has a number of legal, accounting and professional firms who perform the role of local registered agent as is required in the Act.

Essential to the attributes of the offshore services is the guarantee of confidentiality and secrecy. The beneficial ownership of a company incorporated in Antigua cannot be disclosed, except in a court of law, hence nominee shareholders and directors are allowed.

Antigua's Offshore Banking Industry :

Currently there are about 56 offshore banks incorporated in Antigua. About ten of these banks have physical offices and staff based in Antigua, which has facilitated the formation of the Antigua Offshore Association (AOA). A few of these Antigua based offshore banks also have domestic commercial banks affiliates, evidenced by their common private ownership and shared management to varying degrees. The minimum capital requirement for an Offshore Bank is US$1 million, and this must be paid into a bank operating in Antigua, which is acceptable to the Director of IBC's. Licensing and incorporation usually takes about 3-4 weeks. Presumably background checks are conducted by the Director of IBC'S at a cost to the institution. Evidentially however, the Directorate of IBC's has relied heavily on the registered

agents and offshore banks to conduct the required initial screening and information gathering of prospective offshore companies. Verification and "weeding out" of the IBC's and their customers is therefore left largely to the discretion of the individual players, since no standards have been set by the authorities.

Offshore Banks are required to submit quarterly financial reports and annual audited financial statements to the Director of IBC'S. The incorporation fee and annual license fee is US$5000.

Insurance Companies

The minimum capital requirement for international insurance corporations is US$100,000. The incorporation and licensing of an offshore insurance takes about 2-3 weeks.
An insurance corporation must have one resident director, and is required to submit annual accounts to the Superintendent of Insurances. There are about 14 international insurance companies incorporated in Antigua.

International Trust Corporation

The minimum capital requirements for an international trust is US$500,000. A new International Trust Act is soon to be implemented to complement the broad based IBC Act of 1982. The number of international trusts in the island currently stands at 6.

Ship Registration and Shipping Company Formation

Vessels owned by an IBC incorporated in Antigua, can be registered under the flag of Antigua and Barbuda, under IBC Act 1982 No.28. Antigua provides full convention registration and has entered into bi-lateral trading agreements with major trading companies. The vessels pay registration fees and various annual charges for certification.

NEVIS

Nevis entered the world of offshore financial services in 1984 by legislation for the establishment of business corporations. In this scheme, local registered agents were required to have capital of US$185,000. The act was amended in 1994 to permit local barristers, solicitors, etc in St Kitts and Nevis to be licensed as registered agents.

New legislation to modernise the Offshore Financial Services Sector were passed in 1994. These consisted of the Business Corporation Ordinance (Amendment) Act, the Limited Liability Company Ordinance, 1995 and Nevis International Exempt Trust Ordinance. Nevis LLC's are primarily marketed and administered by an agency based in the USA. The effect of these modernised and updated laws is said to have brought Nevis more in line with major centres and provided for confidentiality, security and asset protection.

Since the passing of these legislation, the sector has experienced relatively high growth. IBC's in Nevis are excluded from corporate tax, income tax, withholding tax, stamp duty, asset tax and exchange controls, as in the other jurisdictions.

While the lawmakers have sought to update the offshore legislation, little attention has been paid to the regulation and supervision of the industry. The onus has been left up to the registered agents to exercise due diligence and to protect the reputation of the island.

ST KITTS

Offshore services in St Kitts have developed separately to that of Nevis. In 1992, St Kitts passed the International Business Act, modelled somewhat on the BVI. In 1996, St Kitts revised its International Companies Laws to bring them in line with practices elsewhere, and also introduced the International Insurance Company Act for captive insurance and private insurance

companies. Recognising that the increasing tendency for offshore companies to be owned by Trusts, the Government has also introduced new Trust Laws.

St Kitts has establish an advisory committee to provide technical assistance to the Government on the development and marketing of the offshore financial services, and to identify niche market suitable to the island.

The Authorities are also said to be considering offshore banking legislation, but are proceeding cautiously due to the unsavoury experience of some other islands, where lack of inadequate supervision and regulation invited charges of money laundering and dishonest dealings.

ST VINCENT AND THE GRENADINES

Offshore services are governed by the 1976 Trust and International Companies Act. The 1976 Legislation created the St Vincent Trust Authority Ltd, a Government owned company engaged in the registration of Trusts and international companies. This company is based in Liechtenstien, Europe. Effectively therefore, St Vincent & the Grenadines has not developed the on-shore professional service providers to the offshore sector, as other jurisdictions have attempted to do.

St Vincent & the Grenadine's International Companies Act makes provision for the registration of IBC's, Mutual and Superannuation Funds, Banks, Shipping Companies and Insurance Companies.

As with many other jurisdictions, the formation of an IBC is simple and expeditious. Names can be cleared via telephone and, nominee Directors are provided by the Trusts, who also provide a notarised power of attorney. Minimum capital requirement is US$3,800.

DOMINICA

Dominica is currently seeking to establish a presence in the offshore industry with the passage of recent legislation. The island is seeking to market itself as a low profile, low cost jurisdiction. An offshore financial services unit has been established with the usual under-staffing encountered in the other ECCB territories.

MONTSERRAT

Following the closure of over 300 offshore banks in the late 1980's, Montserrat introduced the new Offshore Banking Ordinance of 1991 to stringently regulate the industry. Only subsidiaries or branches of well established banks will be considered for licensing. Plans are in train to introduce new legislation in the form of a Trust Act, Company Management Act, Limited Liability Act, Limited Partnership, Exempt Insurance Act and a Mutual Funds Act.

GRENADA and ST LUCIA have also commissioned studies in an exploratory step towards the development of the sector. Grenada has also licensed offshore banks under their existing company legislation.

The ECCB Regulatory Framework

The regulatory and supervisory framework of the ECCB financial system is the joint responsibility of the ECCB Monetary Authorities, defined as the Central Bank, and the Ministries of Finance; some aspects rest purely on the Central Bank, others exclusively on the Ministry of Finance of the various countries and yet others are the joint responsibility of the two institutions. This tripartite arrangement among the actors in the financial system has the potential to develop into a three-ringed circus. The enterprises in the financial system can play one agency against the other and exploit any inconsistency and/or uncertainty in policy positions or administrative interpretation of the laws (Nicholls [1993]). For example, the Minister of

Finance issues bank licenses on the advice of the Central Bank. This requires that the application be sent to the Ministry of Finance, which passes it on to the Central Bank for vetting. After vetting, a recommendation is made to the Minister of Finance, based on which he issues or declines the license. The management of such a system calls for an extremely high level of cooperation and exchange of information between the Monetary Authorities.

The Monetary Authorities (ECCB and officials of the various Ministries of Finance) meet at least twice per year to coordinate policy positions and streamline operational issues. In addition, the ECCB is represented at meetings between the Ministries of Finance and various actors in the financial system. All meetings between the ECCB and commercial banks are attended by the officials of the Ministries of Finance.

The major legislation governing the domestic financial system is the Uniform Banking Act, which was passed in the various territories at different dates. It is jointly administered by the ECCB and the Ministries of Finance. In addition, there are other pieces of legislation which impinge on the operation of the financial system, which are exclusively the responsibility of the local Authorities.

The regulation of offshore financial services, in particular offshore banks, poses some ambiguities for the regulatory Authorities. The ECCB Agreement is rather ambiguous on the role of the Bank in the regulation of offshore financial services. The only offshore activity it makes reference to is offshore banks and the mandate is unclear. Article 41(1) states that "the Bank shall act as agent of the Participating Governments in the licensing of institutions" (if the Monetary Council so instructs); and Article 41(2) (3) states that the Bank shall monitor offshore operations including examination of the financial statements, as the law requires institutions to submit." However, the legislation governing the offshore financial services sector are enacted by the individual member countries and have in general not defined a specific role for the Central Bank. The licensing of the financial institutions is under the purview of the Minister of Finance and the Financial Secretary, and where returns are required, they are to be submitted to the Ministry of Finance or the Registrar of Companies. Thus, the regulatory powers devolved

on the Central Bank in the ECCB Agreement has not found expression in the individual legislation of the member countries. This creates a clear need for the harmonisation of legislation governing the functioning of the offshore financial services sector.

In Anguilla the British appointed Governor holds responsibility for the offshore sector. Both the British Government and Anguillan Government express support for the "need for proper regulation of the financial services industry in Anguilla, so as to minimise the risks of the jurisdiction being used for undesirable business", (Victor Banks [1996]). Supervision of the offshore sector is the responsibility of the Superintendent of Offshore Finance.

Anguilla is a member of the Caribbean Financial Action Task Force. It also has legislation which allows for Mutual Legal Assistance Treaties with other jurisdictions. Both legislative provisions are aimed at international co-operation in the investigation of criminal offenses, such as those involving money laundering and narcotics trade. These provisions do not extend to "fiscal" or taxation issues.

The establishment of the Offshore Finance Promotions Agency illustrates that the island has adopted a proactive approach to the development of the industry. Anguilla is actively seeking to develop supporting infrastructure such as law firms, commercial banks, accounting firms, company formation and management firms. One method it has used is to offer multi-year work permits for professionals engaged in the offshore sector, so as to induce them to relocate or set up operations in Anguilla. Such legislation is apparently aimed at attracting non-Caribbean based professionals.

IBC'S in Antigua are supervised by the Director of IBC's in the Ministry of Finance. The chief function of this office is the processing of applications, collection of fees and charges, and the issuance of licenses and certificates of incorporation. The Director of IBC's is empowered by the Act to appoint examiners or himself examine all the books and records of banks, trusts and insurance companies to ensure their solvency and compliance with the Act. For all practical purposes the examination and supervisory function does not take place. The

Directorate is understaffed (virtually one full man operation); moreover, the examination role is not viewed as paramount. The Directorate has relied on the offshore banks and agents to exercise due diligence and to apply the banking principle of "know your customer", in their dealings in the offshore industry.

The Antigua legislation makes provision for an advisory board, whose objective is to develop Antigua as an international financial centre. While such a board has been constituted, the general feeling among offshore financial practitioners is that it has been inoperative and ineffective. A parallel body, the Antigua Offshore Association, which seeks to promote self-regulation of the industry, has been formed to fill the void which exists in the regulation of the industry.

The Way Forward

As the major traditional export commodities come under increasing pressure in international markets and official development assistance begins to dry up, many of the OECS countries are becoming increasingly convinced that the development of financial services has a pivotal role to play in the development of these economies. This is evidenced by the passage of a spate of legislation in this area in recent years. However, given the nature of the industry, it is necessary that serious thought go into the planning for the development of the industry, since a single mis-step in any of the countries can have negative spillover effects on the other members of the currency union which can set the industry back for the foreseeable future. The evidence suggests that in their haste to develop the sector, such level headed analysis has not been done, rather the secrecy and haste to be the first out of the blocks may do untold damage to the industry. However, it is not too late to stop and reflect on the development of the industry. In doing so, the authorities may want to reflect on a number of dilemma which they need to resolve.

This section of the paper attempts to identify some of the issues which the countries would have to resolve if they are to lay the groundwork for a successful offshore financial services industry, and suggests some choices the authorities may want to make.

The locational advantages of financial centres depend on three characteristics. These are the regulatory ease provided by the legislation, the tax incentives provided and the level of financial infrastructure and support services. Because of regulatory arbitrage, financial institutions would locate in less restrictive jurisdiction, which reduces compliance costs and level the playing field for competition with foreign firms. However, as argued earlier, there is a limit to which countries can be lax with their regulatory framework and maintain the integrity of the institution. Given that the OECS countries are short of the supporting services, they would be tempted to provide the locational advantages in legislation but they should be acutely aware of the risks involved in greater laxity of the regulatory framework.

Another related issue is harmonisation of legislation. Harmonised legislation would facilitate the regulation of the industry at the sub-regional level and provide for cost sharing of the regulatory apparatus, which can be extremely costly if it is going to be efficient. However, the advantages provided to the individual countries by the legislation inhere from their uniqueness. Thus, countries would have to determine whether the locational advantages conferred by unique legislation outweigh the advantages of a regional regulatory framework. Given the critical importance of efficient regulation in the long run viability of an offshore jurisdiction, countries may want to forego the short run uncertain benefits of beggar-thy-neighbour regulatory competition and agree on minimum standards, which would enhance the credibility and viability of the sub-regional industry.

A second temptation is to provide 100 per cent tax exemption to compensate for the lack of services. However, a zero tax regime reduces the paper trail which would assist in foiling fraudulent activities. Countries may want to go for a low tax regime within the context of tax planning strategies. In this regard, the double taxation treaties being negotiated jointly by the OECS countries as a grouping, Canada and France may be an integral part of that strategy.

Most of the OECS countries have established Units to manage financial centres, under the supervision of the Minister of Finance, to promote the industry. At the same time, the Minister of Finance is responsible for evaluating application and licensing of the institutions. This arrangement can be a source of conflict of interest for the Minister of Finance, which ought to re-examined. On one hand, the Minister is responsible for the Unit which promotes the industry and would try to get as many of these institutions established. On the other hand, he is also responsible for evaluating applications, which if effective, would limit the number of institutions so established. The Minister ought not be placed in such a position and the promotion and licensing function should be separated.

Public Policy Issues

Two major public policy issues arise from the foregoing discussions. The first is whether the Offshore Financial Services Sector should be allowed to develop as a enclave, with a separate existence from the rest of the domestic financial system. The second is, should the ECCB countries, given the existence of a currency union and a common regulatory framework for domestic financial services, pursue independent development and regulation of offshore financial services. Like most public policy issues, the answers are less than clear, but we hope to provide some guidance on these questions in the rest of this section.

The development of enclave type industries has been advanced on grounds of the unbalanced growth thesis, with the enclave sector being the leading sector which generates the impetus to pull the other sectors along. Empirically, enclave industries have remained just that and created dual economies with a vibrant modern sector in a sea of backwardness. Moreover, high income spillover from the modern sector has resulted in a 'dutch disease' syndrome, which reduces the competitiveness of the other sectors of the economy. Darius & Williams (1996) identify such effects for the Offshore Financial Sector for the British Virgin Islands. Thus, in order to avoid such dualism in the economies, the authorities would have to provide incentives for the development of the domestic financial services sector.

There would be significant synergies in the coordinated development of the two parts of the financial services sector. The ancillary services such as the telecommunications system, money transfer infrastructure, the payments system and general regulatory environment are similar for both sets of activities. In addition, the human resource skills and educational requirements are largely identical (i.e. accountants, lawyers, business majors, executive secretaries, etc.). The development of a viable domestic financial services sector would provide some locational attraction to offshore financial service providers, because they would be confident of being able to recruit some of their skilled professionals locally.

The domestic financial system also provides support to some of the offshore activities, like payments, funds transfers and general banking services. The absence of these services which meet international standards of efficiency may inhibit the development of the offshore sector. There is high level of incongruity in the existence of a Rolls Royce offshore financial system running alongside a horse and buggy domestic one.

The second public policy issue is concerned with who should regulate the offshore financial services industry. If we start from the proposition that the stability of the financial system is a public good, and that the ECCB Area constitutes an integrated financial system, then the theory of fiscal federalism can shed some light on the issue (Musgrave [1969], Oates [1972]). The fiscal federalism literature suggests that public goods should be provided and the cost shared in line with the preferences of the residents of the relevant benefit jurisdiction. In the case of the financial system, the ECCB Area is the benefit jurisdiction. Moreover, an unsavoury reputation in one island has spillover effects in the other territories.

The concept of fiscal federalism may not be quite compatible with the existence of independent nations. In this case, the principle of subsidiarity as applied by the European Union may be more relevant. The principle of subsidiarity suggests that within the context of an integration movement, the smaller units' right to act is operative only to the extent that it alone can act better than a larger unit in achieving the aims being pursued (Cox 1994). An examination of the current arrangements for the regulation of offshore centres in the ECCB Area

suggests that the individual countries acting on their own would not be able to provide an adequate level of regulation. Efficient regulation of the offshore sector requires a variety of specialised skills, which individual countries may not be able to acquire or it may be too costly for them to acquire. A joint approach may be more feasible and less costly in the long run.

Notwithstanding the responsibility of the individual Ministries of Finance to regulate the offshore sector, such regulation has proven to be difficult due to the limited human resources employed in the offshore financial offices, and the overriding promotional emphasis which governs their operations. Given the conflict of interest which inheres from the dual roles of promoter and regulator in the Ministries of Finance, the separation of the promotional and supervisory functions is strongly recommended.

The enactment of recent laws and the take-off to rapid growth for which the offshore sector is poised underscores the need for complementary development in the regulation of the sector. A well regulated offshore financial sector would enhance the region's international image and provide confidence to legitimate investors and management professionals. There are benefits to be derived from the ECCB countries having a similar regulatory offshore environment. Costs and expertise, in limited supply individually, can be pooled. Moreover, the threat of lax regulation in one jurisdiction undermining the reputation of the entire region can be mitigated by a common regulatory structure. The tendency of undesirable agents moving from one Eastern Caribbean jurisdiction to seek accommodation in another, would also be discouraged by the presence of a common regulator.

If we agree that the individual countries may not be able to adequately regulate the offshore financial sector, and that a common regulatory framework is required, the question then passes to what should be the elements of a common framework, which would provide for adequate regulation but also provide scope for individual action on the part of local promotion agencies. The total uniformity of the regulatory framework would be unacceptable to the countries, because it would rule independent action. Moreover, it would have to be supported by a mechanism for allocation similar to the ill-fated Eastern Caribbean Common Market

(ECCM) industrial allocation scheme. The industrial allocations were never adhered to and it is not expected that it would be any different today. The countries would therefore have to agree on a minimum common set of basic principles, which are required to ensure the integrity of the regulatory framework of the jurisdictions. These would include standards and procedures for licensing financial service providers, disclosure requirements, submission of financial statements, etc. Around these, individual countries would be free to compete on the basis of promotion, differences in incentives and ancillary services.

The countries may also wish to provide a set of common services, which would be costly for each individual country to provide. One such service could be an online, twenty-four hour corporate registry, which is critical for competitiveness in the offshore industry. The joint negotiation of more competitive telecommunications rates from the international carriers is another area for joint action. Closer economic integration and the movement of skills among the countries would also suggest the joint maintenance of a labour market information system which catalogues the skills available in the individual countries.

The Structure of the Regulatory Authority

If the countries agree on a common framework for regulating the industry, they would have to decide on the structure of the regulatory Authority. In doing this, three options are available. These are: (i) the existing regulators of the domestic financial system can assume the role of regulator of the offshore financial system; (ii) self-regulation by a body appointed and financed by the industry; and (iii) the establishment of a new body to regulate the sector.

(i) Existing Regulators

Currently, supervision of the commercial banks is the responsibility of the ECCB as provided in the uniform Banking Act. However, in view of its mandate to promote a sound financial system, the ECCB has taken a comprehensive and integrated approach to the development of the financial sector. This is illustrated by the developing relationship with the insurance sector, non-bank financial institutions and its lead role in the development of money and capital market development. Full harmonization of the OECS financial sectors would suggest that the ECCB and Ministries of Finance also collaborate in the development of the offshore financial sector.

Compared to the individual Ministries of Finance, the ECCB is already well equipped with a team of trained and experienced bank examiners, with support available from the Bank's legal department . The institutional framework for the management of the regional financial system is already in place and can be extended with some transformation to encompass the offshore sector. Additionally, extending the regulation of the offshore sector to the ECCB, is likely to be one of the most cost efficient approaches in the short run, since the physical, organizational and human resources, are virtually in place. The reputation and integrity of the ECCB would also inspire international confidence in the sector.

Another benefit arises in cases where domestic commercial banks have interconnected relationships with offshore affiliates. A common regulatory body would improve the transparency in the connected operations of both affiliates, a situation not presently available to the examiners.

Despite the view that the structure of the ECCB lends itself readily to regulate the offshore sector, control for the supervision of the offshore sector is likely to be challenged by other players currently on the scene. The surrender of the regulatory function by the individual Ministry of Finance to the ECCB, will likely require some protracted negotiations to arrive at a framework which would be agreeable to all jurisdictions. The degree of power broking required could vary among jurisdictions depending on their developmental stage and perceived

need for regulation. At best, some minimum level of common guidelines would be required to take account of the individual territorial legislation.

The conduct of monetary policy by the Central Bank and its regulation of the financial sector also raise the spectre of a conflict of roles. As lender of last resort the Central Bank may be forced to intervene in the event of a bank showing signs of insolvency, so as to lessen the systemic risks to the economy. On the other hand, as regulatory of the banking institutions, the Central Bank may be loathe to oversee the failure of a bank it is regulating since there may be grave repercussions for the stability of the economy; and Central Bank intervention would in a sense be required at both ends. The view has therefore been advanced for the supervisory function and the role of lender as last resort, to be managed separately.

Although the lender of last resort role does not extend to the offshore banking sector, the contagious impact of scandal or failures in the offshore sector can rebound to the entire financial system. A conflict of roles could arise with ECCB acting as regulator and stabilizer of the monetary system.

Self Regulation

Self regulation of the offshore industry implies that the offshore institutions themselves take the lead role in the regulation of the industry. Enlightened self interest would lead the major players in the market to behave in a way conducive to the stability of the system. After all, failure or scandal in one institution can bring the others down. Regulation is costly to both the regulators and the regulated. Because there are asymmetries in information between the two groups, regulators would spend time and effort trying to uncover information which the regulated are trying equally hard to hide. In this scenario the regulators are at a decided disadvantage, since the institutions they are trying to regulate are involved in information intensive lending and would know their customers better than the regulators. they are, therefore,

in a better position to undertake risk assessment. With self regulation, the regulators and the regulated are the same and have the same information set. Thus the cost of regulation is reduced. However, since regulation is a public good, a purely private solution may not yield the optimum result, hence the need for some level of regulation by the Authorities.

The Authorities must decide on the most appropriate mix of statutory and non-statutory instruments which meet the objectives, while at the same time maintaining the competitive neutrality of regulation. This requires a tradeoff between the advantages (in terms of flexibility, low administration costs and minimal interference with standard business practice) of self-regulation against the doubts over the effectiveness that non-statutory regulation encourages (Hall [1985]). In general, self-regulation is preferred with the authorities exercising moral suasion with minimal back-up powers to ensure that objectives are fulfilled.

Self regulation could take various forms. One proposal emanating from the Antigua Offshore Association is for a local supervisory body, authorized by statutes, to be made responsible for overseeing the offshore financial sector, with special emphasis on banks, trusts and insurance. The role of such a body would be to screen applications, review financial statements, and biographical review of directors, etc. The Antigua Offshore Association suggested that the officers would be drawn from the legal, banking, and accounting professions, and from the Attorney General's office. The composition of such a body would seem to imply a part time regulatory function for the named officers. This would be cost effective and ensure the involvement of government in recognition of the fact that a public good is being provided. However, the suggestion from the AOA is narrowly focussed on an individual jurisdiction and does not take cognizance of the negative externalities of an under-regulated neighboring jurisdiction.

Another form of self regulation is for a more stringent code of conduct to be imposed on the actors. The institutions will therefore be required by legislation to practice standardized self-regulation, with supervision for compliance bestowed on a regional body. Increasing the responsibility of the offshore banks and agents in the initial screening process is recommended

since this constitutes the point of first contact, and much critical customer information is obtained at this stage. If the first stage weeding out is effective, then the firms which pass that stage would have an incentive to collectively maintain the integrity of the jurisdiction, since failures and fraud would have a contagion effect on the other firms in the centre. However, if the first stage is not rigorous, some of the firms which get through may be willing to take the short term benefits of excessive risk, which could result in failure or be engaged in fraud since they may not be concerned about long run viability.

The self regulated offshore institutions would be subject to periodic examination by the regional body, to ensure their compliance with the regulatory guidelines, and also to ensure safety and soundness in their operations. To counter the occurrence of regulatory arbitrage, a regional self regulatory body is recommended since the islands are at differing stages of development and do not all possess the wherewithal to effectively regulate individually. Since the constitution of such a body would be providing a benefit to all members and a social benefit to the society, it would be likened to a social good, neccesitating some involvement and support by the Government to ensure optimum output.

A New Regulatory Body

The advantages of a totally separate regulatory body for offshore financial services is related to the disadvantages discussed for the other two structures. In particular, the need to provide some statutory regulation in a system of self-regulation, and the inherent conflict between the Central Bank's role as regulator and implementor of policy. There are also some synergies which would arise from the regulation of the money and capital market institutions, which are being established in the ECCB countries. The role of the ECCB in development of money and capital markets creates significant conflict of interest for the Central Bank as promoter and regulator of these institutions. This is in addition to the usual conflicts which exist in its role of policy implementation in markets which it regulates. Thus, the current thinking is in favour of an independent regulatory body for the money and capital market institutions. In these circumstances, it is questionable whether the sub-region can field or can afford to field

three independent teams of regulators for domestic banking institutions, the domestic money and capital markets and the offshore financial sector.

Some amount of rationalisation may be achieved by amalgamating the inspectorate of offshore financial services and the regulatory structure for the domestic money and capital markets. But this still begs the question of two regulatory agencies. Serious conflict of interest would prevent attaching the merged regulatory agency to the Central Bank. Thus, one option may be to sever the bank supervisory functions from the Central Bank, where it is already precariously perched, and create an independent regulatory agency for all financial institutions. The 'super' regulatory agency would have to be independent and free of political interference and be staffed with high quality professionals with the requisite specialised skills.

A common regulatory agency for both domestic and offshore activities would also thwart the efforts of enterprises, which operate in both sectors to exploit weaknesses and inconsistencies between the two regulatory agencies. This could be particularly damaging when there are significant differences in effectiveness between the two agencies and/or when there is little or no exchange of information.

The major drawback would be the cost and funding of the regulatory structure. In order to attract the required skills, the institution may have to incur significant cost. In addition, as part of the Central Bank, the regulatory function shares overheads with the other departments of the Bank, these would have to be fully assumed by the regulatory agency. At present, the governments indirectly subsidise the regulatory functions through a reduction of profits from the Central Bank. Thus, for the individual governments, this is an unseen cost. The financing of the new regulatory would have to be financed by direct payments from governments and fees from the financial institutions to be regulated. Neither of these two groups currently make a direct contribution to regulation, and there may be strong political pressure to maintain the status quo. Thus, the final outcome would boil down to the political power broking by the various players who have a stake in the regulatory framework.

Conclusion

The regulation of offshore financial services has taken on a greater degree of urgency in the Member countries of the ECCB in recent times. As the major traditional commodity export of the countries come under increasing pressure and official development assistance begins to dry up many of them have increasingly shifted their sights to service exports, in particular financial services. In spite of the existence of a currency union and a common regulatory framework for the domestic banking industry, the countries have largely followed a strategy of competition rather than cooperation. This strategy may result in lax regulatory practices in some jurisdictions because currently they are unable to individually field a sufficiently strong team of regulators to cover all aspects of the industry. Apart from encouraging regulatory arbitrage, a competitive strategy may be detrimental to all of the countries if failure or fraud in one jurisdiction has a contagion effect on the other countries in the currency union.

The paper makes a case for a cooperative strategy based a common regulatory framework and the provision of some basic common services. Although a common framework is advocated it should leave sufficient leeway for individual promotion and incentives. Three alternative structures for the common regulatory authority are discussed, viz. expanding the role of the existing regulatory agency, self-regulation and the establishment of a completely new regulatory agency. The paper concludes given the cost of regulation some amount of self regulation may be warranted but this should be complement by regulatory oversight by a common regional public sector agency.

The development of the offshore financial services sector has taken place in isolation from the domestic financial services industry. The paper argues that there can be some synergies in developing the two sub-sectors in tandem. The synergies inhere from the infrastructure, common services and human resource requirements which are almost identical for both sub-sectors. There would also be some advantages in having a single regulatory agency for both onshore and offshore financial services especially where there are players who operate

in both markets. A single agency would avoid a kind of domestic regulatory arbitrage where questionable activities are shifted to the less efficient regulatory agency.

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Appendix

Table 1
Comparison of Fees paid by IBC's
in Eastern Caribbean Countries in US$

	Anguilla	Antigua	Nevis	St. Vincent
Incorporation Fees	250	250	780	572
Annual Govt Fees	200	200	200	437
Local Agent Fees	n.a	250-475	n.a	n.a
Minimum Capital	none	none	none	3800

Table 2
License Fees in Antigua in US$

	General IBC	Bank	Insurance	Trusts
Incorporation Fees	250	5000	2750	2500
Annual License	250	5000	2500	2500
Annual Agency Fees	475-675	6500	3000	3000
Minimum Capital Requirement	none	1 mill	$100,000	$500,000

Table 3
Government Revenues Derived from IBC'S in EC$ million

	1993	1994	1995
Antigua	1.36	1.85	3.29
Anguilla	0.47	0.46	0.66
Nevis	1.47	1.14	1.87