
Global Financial Strategy

REGULATION MATTERS

Don't make international financial centres the scapegoat

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Stikeman Elliott LLP international tax principal Richard Hay argues that so-called tax havens have been given a rough ride in the wake of the crisis despite having robust regulation in place

Globalisation has fuelled an unprecedented leap in world prosperity, doubling world GDP in a single generation. Lowered trade barriers have fostered a globally accessible market, with dramatic improvements in standards of living for both rich and poor countries.

Will plans for expanding regulation of financial services undermine the foundations for this success?

Enthusiasm for big, successful, ideas has a tendency to overshoot, just like investor sentiment for stock markets. The recent financial crisis has prompted a review of the conservative policy consensus which favoured deregulation and globalisation as the twin engines of world growth over the last 30 years.

Domestic politicians and their supranational agencies such as the G-20, International Monetary Fund and the Organisation for Economic Co-operation and Development are riding a tsunami of public opinion seeking change. Recasting the regulatory architecture for financial markets is at the top of the G20 agenda.

The world's tax havens (now termed "small international financial centres" or "SIFCs" in modern IMF parlance) have been singled out for special attention by policymakers.

Despite the prevalence of a perception amongst politicians and the general public that low regulatory standards in SIFCs contributed to the recent financial chaos, the consensus view of technically informed observers (such as the IMF and the Financial Action Task Force) is that the best of such centres (including, for example, Singapore, Hong Kong and many of the British Crown Dependencies and Overseas Territories) have regulation at the leading edge of international standards. If this is true, why are SIFCs so consistently maligned in the mainstream media?

Lazy stereotypes on SIFCs persist. Such stereotypes do not reflect the now pervasive culture in the world's leading financial centres for rejection of tax evading clients who bring trouble in their wake.

Professional probity and high standards of rigorously enforced regulation are the norm in the leading SIFCs following ten years of hegemony for "global" regulatory standards proposed by supranational agencies including the FATF, the OECD and the IMF.

In a curious turn, such standards have generally been more consistently adopted and enforced in the smaller finance centres, while commercial and finance communities in the larger countries have occasionally benefitted from the regulatory arbitrage which flows from fending off implementation of expensive and onerous rules promoted by the agencies they fund and control.

In the current crisis, big country politicians and regulators could be forgiven for seeking scapegoats to deflect criticisms which may otherwise land closer to home.

With notable exceptions SIFCs are not represented in the supranational clubs forging the new architecture; it is generally easier, and certainly more polite, to blame the absent. SIFCs are convenient targets in these fora, as “low tax” and “low regulation” are easily confused and conflated.

The “tax haven” tag implies both, introducing confusion into the debate. A new group with a website at www.ifcforum.org aims to contribute to the public narrative with empirical data to support a more informed analysis.

The leading SIFCs play a key role as lubricants in globalisation. They perform mundane but essential tasks to bridge gaps between complex tax and commercial regimes in the major economies.

The provision of tax-neutral platforms for investment funds illustrates the importance of SIFC activity, facilitating collective investment by disparate investors with widely varying characteristics.

SIFCs function as portals for investment and trade, conferring benefits on wide sections of society who seldom recognise the important role that such centres play in their financial lives.

Ordinary workers, for example, benefit from enhanced returns on their industrial pension funds and improved onshore job creation from trade export activity flowing through such centres.

The benefits of SIFCs are not confined to developed countries. Efficient investment and financial services intermediation by Singapore and Hong Kong materially contributed to lifting 500 million persons out of poverty in China over the last generation.

China adopted a policy of robust support for its proximate tax neutral platforms at the G-20 heads of government summit in April 2009. While discerning Chinese attitudes from afar is never easy, a benign attitude towards SIFC activity may also be inferred from the fact that a feared clampdown never materialised for freewheeling Hong Kong at the time of the 1997 takeover.

Instead, the dirigiste communist government in Beijing studied Hong Kong’s ethos in order to import it directly into the domestic economy through Shanghai.

China has also pointedly maintained supportive relations with many of the leading SIFCs. Could it be that China and other emerging markets see the advantages of a multi-polar world for the delivery of financial services as a counterbalance for the dominance of New York and London?

Competition from vigorous and well-regulated SIFCs may be unwelcome to the dominant countries. Despite formal recognition of the liberalising aspects of competition, most

established producers (including governments) prefer monopolies, or at least manageable cartels. The benefits of competition are widely acknowledged; are financial services uniquely unsuitable for this?

Many domestic politicians regard globalisation with suspicion as it introduces competition, including on taxes. This is despite (or perhaps because) the discipline exerted on government expenditure leaves funds for investment and growth in the productive private sector. Faced with the choice of eating the seed corn or waiting for the harvest, hard-pressed politicians may benefit from external competition to aid them in reaching the right choice.

A key point in the challenge to small financial centres may be the desire by dominant countries to flex control over mobile capital. In a globalising world, is there any more important sovereign prerogative than controlling where mobile money alights? If centres like Jersey, Cayman or Bermuda are rejected by their longstanding natural allies, they could redirect substantial sums elsewhere in the process.

Is it in the interests of Western countries such as the UK and the US to pursue an agenda which damages their symbiotic relationship with the small finance centres which surround them?

The reputation of the UK's offshore centres for probity, professional skills and financial sophistication enables them to attract capital from around the world. Such capital is then substantially directed into the UK, European and US capital, banking and securities markets.

Capital goes where it is welcome, of course, so the erection of US or EU barriers to trade with international financial centres could steer their allegiances towards Asian, Middle Eastern or Latin American markets. Who will suffer most if Western countries' relations with their financial centre territories are damaged?