Timothy Ridley: What makes the Cayman Islands a successful international financial services centre?

Background paper by Mr Timothy Ridley, Chairman of the Cayman Islands Monetary Authority, at the Caribbean Investment Forum, Montego Bay, Jamaica, 12-13 June 2007.

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Introduction

The Cayman Islands' development into one of the world's largest international financial services centres is based on a combination of fundamental core factors – providing the infrastructure, services and operational freedom and flexibility for international investors and businesses on a foundation of stable, certain, intelligent and balanced political, economic, social, legal and regulatory regimes.

The financial services sector was essentially founded by Cayman investing its "historic capital": English common law and tax neutrality (non-discriminatory absence of direct taxes), both dating from the 1700s. Political, economic and social stability completed the platform.

A brief history lesson

Some of the significant decisions and events that shaped the development of the industry over the last 40 years are set out below.

Phase One – 1966 to 1976

The sector was established with the enactment of a handful of laws in 1966, including the Banks and Trust Companies Regulation Law, the Trusts Law and the Exchange Control Regulations Law. The Companies Law had been enacted earlier in 1960 (and with much amendment and enhancement continues to be a crucial part of the legislative infrastructure). In the decade from 1966 to 1976, the sector took root, significantly assisted by political uncertainty in the Bahamas and the development of the Eurodollar market (itself in turn thanks to US interest equalisation tax). At the end of 1976, there were 7,521 registered companies, 126 banks & trusts with assets of US$21.9 billion, and 1 captive insurance company.

Contributing to the local stability was the decision in 1970 for the Cayman Islands to begin issuing its own currency. Prior to this Cayman had used the Jamaican dollar as legal tender, a carry-over from the Cayman's history as a dependency of Jamaica. It was felt that, in view of the rapid progress of the Cayman economy, it would be to the Islands' economic and political advantage for the jurisdiction to have its own currency and a Currency Board (now the Cayman Islands Monetary Authority). Further cementing the Cayman currency's stability was the 1974 decision to delink the currency from sterling and to tie it to the US dollar a relationship that exists today. The country has always enjoyed a healthy surplus in the reserves backing the Cayman dollar.

Cayman's resident population was around 13,000 in 1974.

Phase Two – 1976 to 1986

In 1976, the Confidential Relationships (Preservation) Law (a codification of English common law) was enacted to protect confidential information in the possession of financial services professionals from improper disclosure as a response to aggressive action by the U.S. authorities at the time to obtaining information from offshore banks. All exchange control restrictions were abolished during the late 1970's. The Insurance Law was enacted in 1979, to enhance and regulate the growing captive insurance industry (driven initially by (illfounded) concerns about political stability in Bermuda). There followed again a decade of growth, during which Cayman came into its own in financial services, notably in banking, captive insurance and general financial transactions (e.g., the first euro-bond issue by the Cayman subsidiary of a Japanese shipping company). Towards the end of this period, in 1984, the Cayman Islands entered into the Narcotics Agreement with the U.S., which matured into the

Mutual Legal Assistance Treaty in 1986. At the end of 1986, there were 16,791 registered companies, 456 banks & trusts with assets of US$202 billion, 6 company managers and 107 captive insurance companies.

Phase Three – 1986 to 1996

During the decade 1986 to 1996, robust financial services activity continued over a wide array of areas, notably in on and off-balance sheet secured and unsecured financing, mutual funds and captives. During this time, the regulatory infrastructure became more developed, particularly with the enactment of the Mutual Funds Law in 1993, which provided a secure and clear framework for the fund industry. The Trusts Law and other legislation continued to be amended to maintain Cayman's edge in financial services. At the end of 1996, there were 37,919 registered companies, 575 banks & trusts with assets of US$507.8 billion, 75 company managers, 378 captive insurance companies, 121 mutual fund administrators and 1379 mutual funds.

Phase Four – 1996 to today

In 1996, the Proceeds of Criminal Conduct Law and related anti money laundering regulations were enacted, and was one of the first in the region "all-crimes" anti-money laundering legislation; and the Cayman Islands Monetary Authority (CIMA) was established to replace the Financial Services Supervision Department. In 1997, the Cayman Islands Stock Exchange (CSX) was established. In May 2000, Cayman committed to entering into controlled bilateral on-request arrangements for assisting Organisation for Economic Cooperation and Development (OECD) member states in tax matters.

The first of these was the Tax Information Exchange Agreement signed with the U.S.A in November 2001, with an operative date of 1 January 2004. In June 2000, despite its demonstrated track record in anti-money laundering Cayman found itself on the Financial Action Task Force (FATF) list of non-cooperative countries. We were successful in being removed from that list in June 2001. Cayman also agreed to implement the automatic reporting of interest payments under the EU Savings Directive (EUSD) which became effective 1st July 2005. A key benefit secured by Cayman was that all but one of its mutual fund categories were agreed to be "out-of-scope" of the EUSD.

The Securities Investment Business Law was enacted in 2001 and provided for the licensing of investment managers and advisors.

At the end of 2001, mid-way through the decade 1996-2006, there were 64,495 registered companies, 427 banks with total assets of over US$800 billion, 3,648 mutual funds, 542 captive insurance companies, 418 listings on the CSX with a market cap of US$38.1 billion, 92 company managers, and 217 mutual fund administrators.

In 2002, CIMA became fully independent operationally in keeping with international expectations and standards. In late 2003, Cayman was assessed by the International Monetary Fund (IMF) and received a report confirming substantial compliance with international regulatory standards, with particular emphasise on the strong and effective anti money laundering culture.

Current

The financial industry continues to show strong growth in most areas. Figures for year-end 2006 show the number of active registered companies had grown to 81,783, a 27% increase from 2005. The CSX had 1,225 listings with total market capitalization of US$111.5 billion, after reaching its milestone of 1,000 listings in 2005. Investment funds grew to 8,134 an increase of 14%. Cayman continues to be the world's number one domicile for hedge funds and for structured finance transactions. We also continue to hold our own as the number two jurisdiction after Bermuda for captive insurance companies, with consistent growth to 740 as at December 2006. The number of trust companies and company managers remains relatively stable with some modest growth in the number of private trust companies.

The lone departure from the numerical growth trend is on the banking side, where consolidation and cost-efficiency considerations continue to have an impact, with the number of licensees at the end of 2006 down 3% from 2005 to 291. However, the quantum of assets on deposit (overwhelmingly institutional funds) at around US$1.4 trillion continues to climb, with Cayman remaining by far the biggest offshore bank booking centre.

Cayman continues to update and enhance its key regulatory laws and regulations and anti money laundering regime to maintain its competitive position and to meet appropriate international standards.

The resident population is now over 50,000, i.e. nearly 400% growth in 33 years.

This brief historical review not only demonstrates the consistent growth that Cayman has experienced as an international financial services centre, but shows that growth has gone hand in hand with policy and legislative development and international cooperation.

Where is Cayman going?

Successive Governments have maintained a firm commitment to providing the necessary policy and legislation to facilitate orderly development as Cayman has ventured into new sectors, to support innovation, to safeguard its industry from abuse and to fulfil its international obligations as it has advanced to become a major participant in global financial services. Set out below is what Cayman is now doing and how it does it, and highlights the main challenges.

Philosophy

Cayman takes a principled and pragmatic approach to the development of the financial services industry in the Cayman Islands. In terms of principles, our "operating manual" is based on

- **Adherence to recognized relevant international standards** – Cayman fully accepts that it should adhere to generally accepted and applied international standards – and not just as they are, but as they evolve. Cayman's experience has been that it is not absence of regulation that has promoted business, but the introduction of sensible and balanced regulation as circumstances demanded. The growth of the financial services industry over the last four decades is proof of this.
- **Proportionality of regulation** – the jurisdiction operates on the principle that, before a regulatory measure is introduced, we must be satisfied that it is necessary, it is appropriate given the nature of financial services business in the Cayman Islands, it is proportional to the identified risks, we understand the regulatory impact and its benefits outweigh its costs.
- **Respect for the rule of law, due process and the right to privacy of personal financial information** – this speaks for itself.
- **Progressive reinforcement of our international cooperation channels** – evidenced by the Mutual Legal Assistance Treaty and Tax Information Exchange Agreement with the U.S.A; the Proceeds of Criminal Conduct Law; the Monetary Authority Law; the Terrorism Law; the Criminal Justice (International Cooperation) Law; and willingness to negotiate additional agreements for cross border cooperation and information exchange with key jurisdictions.
- **Constructive engagement on international issues in the provision of cross-border financial services** – based on a level playing field and encompassing equity, fair competition, transparency and non-discrimination.

These all promote legal and commercial certainty and control reputational risk for Cayman and users of the jurisdiction.

The tools

Public sector infrastructure

The public sector support infrastructure includes a number of key institutions. These are:

- **Minister, International Financial Services Policy** – with oversight of two key bodies – the Financial Services Council and the Private Sector Consultative Committee.

- **Portfolio of Finance & Economics** – under the leadership of the Financial Secretary, Deputy Financial Secretary, also includes The Secretariat (policy), Public Relations Unit, Tax Information Exchange Authority, Anti Money-Laundering Steering Group.
- **CIMA** – regulates the financial sector, (including monitoring for compliance with AML/CFT requirements), i.e. banks, money services providers, trust companies, securities (investment funds, fund administrators, brokers, investment managers), insurance (captives, general, managers, and agents), company managers and corporate service providers.
- **General Registry** – registry for companies, exempted partnerships & trusts, patents & trademarks.
- **Cayman Islands Stock Exchange** – from its start as a listing facility for Cayman Islands' specialist products, mutual funds and debt securities, the CSX has emerged as an innovative, global gateway to accessing capital markets in ten years.
- **Financial Reporting Authority** – similar to U.S.-based FINCen, UK NCIS and other international financial crime reporting agencies around the world.

Private sector

The private sector is a critical component of the infrastructure. Over the years Cayman has built up a world-class cadre of professionals who have facilitated specialization in institutional high value business. Our growing law firms routinely rank very highly in these main areas of specialization, and all of the "Big 4" accounting & auditing firms have significant offices here. Among our banks are 43 of the top 50 international banking houses. There is a large number of top quality service providers for fund administration, insurance and company management and fiduciary services, both independently owned and members of well-known international groups.

The special relationship

The relationship between the Government and the private sector is one of the strengths of the Cayman Islands' financial industry. There is a culture of consultation and cooperation. At the central Government level this is facilitated through the two bodies already mentioned, the Financial Services Council and the Private Sector Consultative Committee. These two standing groups provide Government with valuable advice, input and feedback on financial and economic initiatives. Private sector consultation is also a formal requirement for CIMA. The Monetary Authority Law stipulates that prior consultation must occur before the regulator issues or amends rules or statements of principle or guidance regarding the conduct of licensees. Industry-CIMA-Government working groups are frequently used to address sectors requiring attention. Recent examples are the insurance and mutual fund industries.

Challenges

The high tax v low tax battle

The principal ongoing challenge for the Cayman Islands, and one faced by other small financial services centres, is the pressure from leading economic powers (and their client international agencies such as the OECD) to curtail the activities of these centres, that are seen as diverting tax revenue from the public coffers of these higher tax jurisdictions. The latest initiative is the current offensive in the United States Congress against perceived "tax havens" by proposed new tax legislation blacklisting such centres and deterring U.S. taxpayers from using them.

The Cayman Islands is responding to this with efforts to ensure that decision-makers and influencers understand the Cayman Islands regime and our associated international cooperation channels, as well as the effectiveness of those channels (particularly under the Mutual Legal Assistance Treaty and the Tax Information Exchange Agreement with the U.S.). Cayman is also actively considering tax information exchange agreements, double tax treaties or comprehensive tax agreements with key jurisdictions. Its position is that there must be real and measurable benefits to Cayman under any such agreements.

International standard setters

Cayman has been periodically challenged by international standard setters with their establishment and revision of standards, which Cayman and similar jurisdictions usually have not had a hand in developing, and the resulting sanctions unilaterally imposed for perceived non-compliance. As mentioned above, Cayman was placed on the FATF list of noncooperative countries in 2000. It also felt the brunt of the OECD's harmful tax competition initiative during that period, and subsequent initiatives since that time.

The primary strategy is to engage these standards setters in dialogue so as better to inform them as to the regulatory regime in Cayman and to secure Cayman's early participation in framing international standards that are accepted and applied by all. Currently, Cayman is engaged in this exercise with the International Organisation of Securities Commissioners (IOSCO) and the International Association of Insurance Supervisors (IAIS). The Caribbean Financial Action Task Force mutual evaluation now underway and the IMF assessment in late 2007 will provide further opportunities for dialogue.

Other challenges

- **Natural and man-man shocks** – Hurricane Ivan in 2004 underscored Cayman's vulnerability to natural disasters, in particular hurricanes. The financial sector proved itself very resilient in the aftermath of Ivan, thanks in part to its business continuity planning. However there were areas of weakness, and since that time industry and Government have been working to address these. The Government has strengthened its ability to handle large-scale emergencies with the recent establishment of an emergency management agency. CIMA has also issued a statement of guidance on business continuity for all licensees.
- **Immigration/Human Resources** – there is a worldwide shortage of skilled labour to support the financial services industry. Cayman is an expensive location in which to do business and live. Just as Cayman has been the beneficiary of outsourcing of financial transactions from high tax and overregulated jurisdictions, so it must accept that many support functions will be outsourced by its service providers to lower cost jurisdictions. This makes it ever important that Cayman focuses on delivering high value added services and providing better education and opportunities for the local community while continuing to welcome those with the needed skills that Cayman has not yet developed at home.