CONCEALING THE BENIFICAL OWNER (I)

The Offshore Financial Centres

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Faced with the threat that the public may lose its confidence in the financial world, the international community has decided to uncover the numerous disguises used by criminals. This two-part series focuses on a number of important disguises, and the initiatives taken to resolve the problem of the concealment of beneficial owners. In the first part, we will look at the Offshore Financial Centres. This two-part series centres around the US legislative proposal HR3886. The aim of this legislative proposal is to facilitate the identification of the beneficial owner. Of course, the question remains whether this aim will be achieved or whether, as it appears now, the problem will simply relocate.

On 9 March 2000, the legislative proposal HR3886 was submitted to the US Congress. The legislative proposal, known as *the International Counter Money Laundering Act 2000*, can have far-reaching consequences for the set-up of the international funds transfer system, the routing of payment traffic between international banks and the role of the dollar as international tender. HR3886 is aimed at making it easier to identify the beneficial owner (the ultimate owner) of a foreign bank account, because, at the moment, it is still possible for the beneficial owner to hide behind a whole range of disguises. The tax havens play an important part in providing disguises because, in addition to fiscal and corporate liberties, they also offer clients numerous protective and obscure constructions. Although tax havens are not explicitly identified in the legislative proposal, the current international developments demonstrate that the services on offer in the tax havens have been a thorn in the flesh of the international community for years now. The US discontent is clearly expressed in the legislative proposal with the arguments that: '*(...) international money laundering provides the financial fuel that permits international criminal enterprises to conduct and expand their operations to the detriment of the safety and security of American citizens. Money laundering subvert legitimate financial mechanism and banking relationships by using them as protective covering for the movement of criminal proceeds and, by so doing, can undermine the integrity of our financial institutions and of the global financial and trading systems upon which our prosperity and growth depend*'.

Part 1 of the article first deals with the most recent important, international political developments in the area of money laundering, as recently expressed in the reports and press publications of a number of authoritative bodies. It stands to reason that the offshore financial centres (OFCs) and offshore banks are the current focus of attention for the international community. In the press and literature dealing with financial crime, OFCs and offshore banks are often synonymous with financial refuges for criminal and black money; however, they also have their positive side in the financial world. When looking more closely at these different contexts, it will become clear that

the problems identified by the US legislator are not limited to the Caribbean or Atlantic tax havens, but that they also extend as far as the non-resident (NR) circuits across the Western world. The legislative proposal, in contrast, is exemplary of the fragmented approach to the money-laundering problem. Instead of working towards joint international measures, the US legislative proposal is aimed exclusively at dollar transactions. As a result, the actual money-laundering problem will shift to different currencies. For the purpose of this article, therefore, the legislative proposal will merely function as introduction to the actual problem: the various opportunities the beneficial owner has to hide and to conceal his/her identity.

Part 2 of this article, therefore, will highlight the problem of money laundering in the NR circuits, and explain the most relevant aspects of the problem. In the first instance, the registration and availability of the relevant data relating to the nature and the scale of the NR circuits in the different countries are highlighted, followed by a discussion of the stakes and interests of the authorities – police, justice departments and tax authorities – concerned. Subsequently, the possible consequences for international funds transfers and role of the dollar are described in more detail. Finally, we take a brief look at one of the most recent initiatives by the Organisation for Economic Co-operation and Development (OECD) to introduce tax harmonisation as a means to tackle one of the most important driving forces behind tax evasion.

International developments

The immediate cause for the legislative proposal HR3886 is very likely to be the most recent earthquake in the US financial world. This shock, with a financial impact of tens of billions of dollars, took place in 1998 and hit, among others, the Bank of New York and was caused by the Russian mafia. The tremors shook the confidence of US politicians in the financial institutions to its foundations and resulted in the call for drastic measures to avoid repetition. Other upheavals in the international financial system, such as the crises in Asia and the near-ruin of the US hedge fund, Long Term Capital Management, and also the shockwaves around the Bank of Credit and Commerce International (BCCI) debacle in 1991 and the European Union Bank in 1997, were the reason for the formation of the Financial Stability Forum (FSF) by the ministers of finance of the G7 countries. Recently, FSF working groups published five reports, including the *Report of the Working Group on Offshore Centres*. In this report, eleven recommendations invite the 'less vigorously regulated' OFCs to demonstrate their goodwill by implementing important international standards for supervision and cooperation, resolving present shortcomings, allowing reviews by external experts and publishing the results of these.

The concern about developments in OFCs, as expressed in the reports by the FSF working groups, is also reflected in the most recent report, of 14 February 2000, by the Financial Action Task Force (FATF), entitled *Report on Non-Cooperative Countries and Territories*. As the title already suggests, the FATF persevered with the initiative to identify countries and territories that are not prepared to adopt and implement the forty internationally accepted basic measures against money laundering. To identify these obstructionists, a rule of twenty-five criteria has been agreed. Areas of attention include the effectiveness of the preventive measures and the detection systems, and the results of the repressive judicial efforts, all in the area of money laundering. Here, too, the need for

this step is substantiated with the arguments that '*(...) in order to ensure the stability of the international financial system and effective prevention of money laundering, it is desirable that all financial centres in the world should have comprehensive control, regulation and supervision systems. It is also important that all financial intermediaries or agents be subject to strict obligations, notably as regards the prevention, detection and punishment of money laundering*'.

In recent times, a number of different countries have bowed to the pressure from the FATF to introduce the required measures. Austria, closely followed by Liechtenstein, was threatened with suspension because it had still not taken adequate steps to put an end to the practice of numbered (anonymous) accounts. At the last moment, the Austrian government conceded to the wish of the international community, as represented by the FATF. Out of fear for the irreparable damage to the reputation of Austria as a financial centre, a bill was passed and became law on 1 November 2000, which prohibits the opening and owning of anonymous bank accounts.

On 22 June 2000, the FATF published the *name-and-shame list*, identifying 15 countries that have serious problems with the implementation and improvement of legislation and regulations to combat money laundering. Virtually simultaneously, the Committee on Fiscal Affairs of the OECD handed over a report entitled *Towards Global Tax Co-operation; Progress in Identifying and Eliminating Harmful Tax Practices* to the responsible ministers of the countries in question, which describes the OECD's efforts in identifying and eliminating harmful tax practices. The publication of this report aims: '*(...) to secure the integrity of tax systems by addressing the issues raised by practices with respect to mobile activities that unfairly erode the tax bases of other countries and distort the location of capital and services. Such practices can also cause undesired shifts of part of the tax base to less mobile tax bases, such as labour, property and consumption, and increase administrative costs and compliance burdens on tax authorities and taxpayers*'.

Following this report, six tax havens indicated their willingness to embrace the proposed measures for drawing up international standards to cover transparency, information exchange and honest tax competition.

In the report, *Financial Havens, Banking Secrecy and Money Laundering,* compiled at the request of the United Nations and well worth reading, questions are raised about the existence, the function and the present regulation of the offshore banks. Although the importance of these financial institutions as lubricants for the entire international financial system should not be underestimated, the report points out the risks and the debacles in recent years around offshore financial centres and offshore banks. In the same breath, questions are also raised as to the usefulness of the bank secrecy, which not only stands in the way of proper supervision of offshore banks, but which is also misused to protect individual interests at the cost of the public interest. '*When the issue of legal accountability is at stake, the right of privacy must give way*'.

The developments described above reveal that the international attention successively shifts from form to content. In the period following the signing of the Treaty of Vienna and the Treaty of Strasburg, extensive energy was invested in the legal basis for tackling the money-laundering problem. In short succession, many countries, in one way or another, made money laundering a punishable offence, statutory regulations were introduced to obligate financial institutions and other professional groups to supply

certain information to investigating authorities and international agreements were made regarding cooperation and the exchange of police and legal information. This race to catch up resulted in a rather legal framework, which, with the required effort and knowledge, should make it possible to overcome most of the money-laundering problem. We can, therefore, conclude with some satisfaction that, with the publication of the aforementioned reports, we have entered a new era, in which countries are appealed to directly about fulfilling their international obligations, and in which the nature and effectiveness of measures they introduced are reviewed. The coming years will show whether the investigating authorities know how to use the building blocks provided to stem the tide or whether the flows will unexpectedly create a new delta in which new 'islands' arise.

Offshore Financial Centres

The worldwide need for companies and individuals to also have financial means at their disposal abroad increased exponentially after the Second World War. Causes of this increase include the liberalisation of world trade, the accompanying abolition of credit and currency restrictions and the growing demand for capital to finance the development and expansion of new economic activities. A number of causes can be identified as a result of which certain countries operate as financial intermediaries in international funds transfer: in the first instance, the inequality in economic and political development rates between countries. Secondly, the frantic attempts by umbrella bodies and affiliated central governments to regulate international funds transfer. Finally, in smaller countries, socio-political developments play an important role. All these financial intermediaries are know as Offshore Financial Centres (OFCs).

At the end of 1997, the Bank for International Settlement (BIS) and the International Monetary Fund (IMF) confirmed the existence of 69 OFCs, which, at that time, accounted for a 54.2% share in the total cross-border ownership of financial means. This share represented a value of USD 4,800 billion at the time, and grew annually by more than 6%. The BIS also calculated that, between 1992 and 1997, an average 85% of the total cross-border ownership at the OFCs was kept in the form of bank balances.

Most of the smaller OFCs usually have a narrow economic base relying on agriculture and tourism and are faced with the additional problem of a relatively rapidly growing population. In order to earn additional income, they award special privileges to foreign banks, companies and individuals. The opportunity of easier access to the international capital market, the introduction of an element of competition for low-risk local banks and the creation of new employment opportunities are frequently cited as reasons for developing economies to act as OFCs. In the background, the socio-economic necessity to maintain a link with international economic developments plays an important role. The fear of being stuck in a supporting role as a developing country on the fringes of the economic world is the driving force for many OFC governments to take up an important position in the world of high finance.

The facilities offered by OFCs include low tax rates (or lower fiscal thresholds), access to important financial centres, a minimum of formalities for establishing legal entities and strict banking secrecy rules for bank employees and consultants. Everything – frequently in an idyllic setting, with well-educated consultants, the presence of branch offices of international banks, good accessibility, high-quality communications systems

and a well-developed legal system, in which the integrity of the relationship between principal and agent is properly protected.

It is clear that the governments of the OFCs strive for a broader economic base for their countries and, therefore, they are prepared to set aside internationally accepted banking standards. A significant part of this base is dependent on the presence of substantial cash balances; at the end of 1997, these represented a total of USD 4,000 billion. It is clear that the broadening is, in fact, only based on the brief availability of cash at banks and in hand, in which the desired continuity in the form of substantial economic activities is entirely absent. This, then, is also the reason for the OECD to call upon the smaller OFCs, in its report *Towards Global Tax Co-operation,* to eliminate harmful tax practices that affect the tax base in countries, disturb trade and investment development and undermine the honesty, neutrality and social acceptance of tax systems. In the longer term, these harmful practices will harm global prosperity and damage the taxpayer's confidence in the integrity of tax systems.

The concept 'offshore'

In our international community, it is increasingly the case that private and public institutions, from different contexts, have both direct and indirect contact with offshore centres and offshore banks. The private institutions can be divided into two categories: financial institutions and international accountancy and consultancy firms, as providers of financial products and fiscal constructions. In addition, multi-nationals and many other international companies are customers of these services. On the other hand, public institutions, such as supervisory bodies, tax authorities, police and justice departments, in the context of their tasks under public law, are regularly confronted with unusual financial transactions and issues relating to profit appropriation and tax planning. The growing complexity, as a result of the internationalisation, the different tax and legal systems, the changing political and economic situation and the different internal and external interests of the private and public companies concerned, leads to obvious misunderstanding and confusion about the meaning of the concepts 'offshore centres' and 'offshore banks'. Firstly, about the meaning and role of the offshore centres and offshore banks in international funds transfer and, secondly, as a result of a fragmented insight the involved parties have into the problems arising from the character of these centres and banks. The chance is therefore considerable that, with the introduction of the legislative proposal HR3886, the US legislator will not get to the heart of the problem, but will only treat the symptoms. This is a case of superficial measures, with the result that the real problem, the opportunities the beneficial owner has to conceal his/her identity, is pushed away under water, without knowing where it is going to resurface again. It will not be the first time that the introduction of a new legislative measure results in the relocation of the problem. The legislative proposal in question aims to facilitate the identification of the beneficial owner in the case of obscure financial transactions; however, it is clear that it is only focused on and limited to dollar transactions. Given the aforementioned international developments to abolish the loathed protective and obscure constructions, first consideration is given to transactions concluded via OFCs and offshore banks.

Errico and Musalem, therefore, describe offshore banking as '*(...) a pervasive activity both with respect to the number of offshore financial centres (OFCs) and the volume of transactions. A number of factors ranging from favourable regulatory*

frameworks and convenient fiscal regimes, to the possibility of engaging in illegal activities, including money laundering, continue to attract business to OFCs. Offshore banking appears to be a particularly appealing option to the sometimes heavily regulated and maturing financial markets of emerging economies, especially those experiencing sustained high growth rates and in need of investment financing'.

In brief, four different contexts can be distinguished for the English concepts 'offshore' and 'onshore', which are relevant for the purpose of this article.

In the business economics (banking) context

From a business economics point of view, foreign branches of a bank are defined as offshore banks. Following the internationalisation, the liberalisation of regulations en the aim for far-reaching economies of scale and cost reduction, the financial world, in particular, has seen a real flood of acquisitions, as a result of which many smaller, usually domestic or regional banks are now fully or partly in the hands of financial conglomerates. Partly due to local legislation, these foreign banking subsidiaries usually maintain an independent position with respect to the parent bank, which means that the performance of these offshore branches is assessed on the basis of autonomous business units. Whether or not these foreign branches are based in tax havens is not relevant in this context.

In the context of business economic supervision

Within the framework of business economic supervision, the central banks have reached agreements over the years about the minimum requirements, the coordination and the implementation of the supervision of the internationally operating banks with their foreign branches and the independent banking subsidiaries. A bank is then described as an offshore bank if supervision of the foreign branch is carried out by the foreign supervisory body, the offshore authorities, and not by the supervisory body of the banking holding company, the onshore authorities.

N.B. Errico and Musalem distinguish between three categories of OFCs: primary, secondary and booking centres. The first category, the most dominant group of OFCs as regards scale, consists of specially formed territories in leading countries in the financial area. In these territories, also known as free-trade zones, renowned international banks can obtain a licence to operate as intermediary on the extensive international capital market. These banks are supervised by the onshore authorities.

The second category OFCs usually acts as brokers in attracting or distributing money on the regional capital market. As a result of obscure ownership constructions of the financial institutions in question, the supervision of this category to this day leaves much to be desired.

The final category is not so much involved in global and regional brokering but, as a result of the far-reaching fiscal and corporate facilities offered locally, acts more as base for these participating parties Partly due to this, these OFCs are known as refuges for criminal and black money. In many instances, two supervisory bodies are involved in the supervision of the banks and subsidiaries based here. In some cases, the onshore authorities supervise the financial conglomerate, but often, the supervisory body in the country where the subsidiary is based will be responsible for the supervision of that

subsidiary.

From a technical tax perspective

In the technical fiscal context, the concept 'offshore centre' concerns countries and territories, which apply attractive tax facilities with the specific aim of attracting investors and savers. Due to a number of circumstances, these countries have become a 'safe haven' for flight capital for customers for fiscal, privacy or other reasons. In the first instance, the low or non-existent tax burden and the absence of tax treaties with other countries, whether or not in combination with legal provisions that the information divulged cannot be used for tax purposes. In the second instance, a banking secret, simple and speedy procedures for establishing legal entities, usually with bearer shares, and the absence of accounting and publication duties. The reader will therefore not be surprised to discover that in 1998, the OECD nominated a number of these elements, as well as insufficient transparency and the lack of information exchange as core factors for the identification of harmful tax practices.

In the context of the registration of money flows

The international transactions in goods, services and capital returns on the current account and the investments, the securities transactions and the banking transactions become visible in a country's balance of payments. The balance of payments, therefore, also forms an important basis for analysing the macro-economic and monetary policy of a country. For the registration and description of the nature and scale of the economy, the transactions between residents (R) and non-residents (NR) are important; the transactions between residents mutually (also known as onshore flows) and between non-residents mutually (in this context, offshore flows) do not affect the economy in question and, as such, are neutral. For the technical registration of the primary data that form the basis for the balance of payments, a distinction is made, pursuant to international agreements, between resident bank accounts (R accounts) and non-resident bank accounts (NR accounts). Furthermore, it was agreed that two registration methods, the gross and the net method, will be used for the registration of international money flows. In some countries, e.g. the Netherlands Antilles, the irrelevant money flows between the NR accounts are not registered in the net method, whereby it is impossible for these flows to be included at all in the balance of payments and the macro-economic analysis. In other countries, including the Netherlands, all money flows are included in the gross method, after which the money flows between NR accounts are removed from the totals before the macro-economic analysis. An important advantage of the registration method is that it creates insight into the volume of the NR circuit. In countries where the transactions between residents mutually (R circuit) and non-residents mutually (NR circuit) are excluded from registration in advance, there is only a very fragmented picture of the nature and scale of what happens in the payment circuit.

One could, therefore, draw the conclusion that it is possible to use the concepts 'offshore centres' and 'offshore banks' in different contexts. The first three lines of approach to the concepts are relevant in dealing with the money-laundering problem in the OFCs, while the final line of approach can serve as a step to the second part of this article. In the next part, we will focus on the money-laundering problem and the opportunity the beneficial owner has to conceal his/her identity by using the NR circuits.

Conclusion

The introduction of legislative proposal HR3886 is in line with international developments to deprive organised crime of the financial fuel for setting up and sustaining its criminal practices. A new period has dawned with the publication of reports by a number of authoritative institutions, in which the focus of attention is shifted from the legal to the practical aspects surrounding the money-laundering problem. On the other hand, countries are challenged directly for not observing their international obligations or for not taking sufficient and proper measures. The focal point of the international attention is on the offshore centres and the offshore banks because, in addition to fiscal and corporate liberties, they also offer their customers many undesirable protective and obscure constructions. The fact that the content and continuity are totally lacking in the usually smaller OFCs is demonstrated by the immediate availability of substantial volumes of liquid resources. The wish to avoid the role as developing country has prompted OFCs to set aside international standards, thus becoming a safe haven, dubious or not, for flight capital. The international community has finally decided to identify non-cooperative OFCs, to draw up a name-and-shame list and has warned the perpetrators to introduce measures. Failure to introduce adequate measures can result in appropriate sanctions being taken against the countries in question. In brief, the first part of this article leads to the conclusion that the international community, with the US Congress taking the lead, has launched the necessary initiatives to remove unacceptable disguises. For the time being, international attention is focused on the OFCs, but an important part of the problem can be found closer to home, on our very doorstep. More about this in part two.

Noten

1. Marcel Cassard, *The Role of Offshore Centres in International Financial Intermediaition*, IMF Working Paper WP/94/107, September 1994.
2. Het faillissement van de European Union Bank wordt uitgebreid beschreven in *Financial Havens, Banking Secrecy and Money Laundering* van Jack Blum et al, United Nations, 1998.
3. De jurisdicties met belangrijke financiële offshore activiteiten worden onderverdeeld in drie groepen. Groep 1 bestaat uit Hongkong, Luxemburg, Singapore, Zwitserland, Dublin, Guernsey, Isle of Man en Jersey. Groep 2 uit Andorra, Bahrein, Barbados, Bermuda, Gibraltar, Labuan (Malaysia), Macau, Malta en Monaco. De derde groep bestaat uit de Caribische en Atlantische Eilanden, Costa Rica, Cyprus, Libanon, Liechtenstein en Panama.
4. Financial Action Task Force, *The Forty Recommendations*.
5. Financial Action Task Force, *Review to Identify Non-Cooperative Countries or Territories: Increasing the Worldwide effectiveness of Anti-Money Laundering Measures*, 22 June 2000.
6. Bermuda, de Kaaiman Eilanden, Cyprus, Malta, Mauritius en San Marino zijn in tegenstelling tot 35 andere belastingparadijzen wel bereid om hun gunstige belastingregimes aan te passen.
7. Jack Blum et al, *Financial Havens, Banking Secrecy and Money Laundering,* United Nations, 1998.
8. Ter bescherming van de veelal kwetsbare lokale economie mogen de buitenlandse banken en vennootschappen vaak in het land van vestiging geen activiteiten ontplooien. Het feit dat een offshore center de behoefte heeft zijn eigen economie te beschermen door ‘ring fencing’ wordt als een belangrijke indicatie gezien dat het onderhavige land bewust faciliteiten aanbiedt die schadelijke gevolgen voor andere landen kunnen opleveren.
9. Lucca Errico en Alberto Musalem, *Offshore banking: An Analysis of Micro- and Macro-Prudential Issues*, IMF Working Paper WP/99/5, January 1999.
10. David L. Mckee, Don E. Garner en Yosra AbuAmara McKee, *Offshore Financial Centers, Accounting Services and the Global Economy,* 2000.
11. In dit verband kan verwezen worden naar de invoer van de Wet Melding Ongebruikelijke Transacties,

die een sterke toestroom van geldwisselaars vanuit Nederland naar de ons omringende landen tot gevolg heeft gehad.

12. In 1975 is in de *Basle Concordat* door het BIS de eerste poging vastgelegd om tot afspraken voor het toezicht op internationaal opererende banken te komen. Naar aanleiding van het faillissement in 1991 van de Bank of Credit and Commerce International (BCCI) is het rapport *Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments* in 1992 door het Basle Committee for Banking Supervision uitgebracht.
13. De buitenlandse toezichthouder moet ook in staat zijn het toezicht op de vestiging van de bank op een kwalitatief hoogstaand niveau uit te kunnen voeren. De uitwerking van de afspraken over het niveau van toezicht en de uitvoering zijn in 1996 door het Basle Committee for Banking Supervision en de Offshore Group of Banking Supervisors vastgelegd in het rapport *The Supervision of Cross-Border Banking*.
14. Deze toonaangevende centra zijn Londen, de US International Bank Facilities, de Japanse Offshore Market, de Bangkok International Banking Facilities en de Labuan International Offshore Centre in Malaysia.
15. Belangrijke regionale centra zijn Hongkong en Singapore voor Zuid Oost Azië, Bahrein en Libanon voor het Midden Oosten, Panama voor Latijns Amerika en Luxemburg voor Europa.
16. Tijdens de crises in Zuid Oost Azië en Zuid Amerika bleek dat adequaat toezicht op deze OFCs ontbrak, waardoor vroegtijdige signalering van de financiële problemen niet mogelijk was.
17. Organisation for Economic Co-operation and Development, *Towards Global Tax Co-operation; Progress in Identifying and Eliminating Harmful Tax Practices*, Paris, June 2000.
18. Organisation for Economic Co-operation and Development, *Harmful tax competition; An Emerging Global Issue*, Paris, April 1998.