International Financial Services – the winners and the losers

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In my 900-page economic Report on the Economic, Socio-Economic, and Regulatory Impact of the Tax Savings Directive and EU Code of Conduct for Business Taxation upon Selected Offshore Financial Centres as well as a Competitiveness Report for Selected Offshore Financial Centres (Foreign Commonwealth Office 2004), I examined and calculated the economic size and impact of the sector on local jurisdictions. But for periods of global financial crisis, the sector had experienced *double-digit* annual growth and contributed robustly to the local economy and society. Since 1998, the international financial services sector client base has expanded nearly 10% on average. During this period, the number of High Net-Worth Individuals (HNWI) clients *Offshore Investment* readers serve has more than doubled, to just over 10 million, as have their assets, from USD17.4 trillion to USD40.7 trillion.[1]

It's getting better all the Time

In just four years, the pool of HNWI clients assets will grow another 50% to nearly USD60 trillion. The average HNWI, excluding the value of primary residences and collectables, is worth more than USD4 million! HNWIs continue to leverage offshore skill sets, growing their assets from USD5.8 trillion from 1998 to USD11 trillion today.[2] That USD11 trillion under management represents, at combined fees of just 1%, at least USD100 billion to Offshore Investment (OI) firms.

The Lull before the Storm?

The year 1998 ended on a sour note with doom and gloom pundits prophesising the OI sector's contraction in response to the OECD's 'Harmful Tax Competition' report. However, I continued to evangelise a robust sector with expanding career opportunities and higher compensation packages. The litany of annual high tax country reports and supporting new regulations, including the 2000 release of the OECD's 'Improving Access to Bank Information for Tax Purposes', the 2001 IRS Qualified Intermediary agreements, the signing of TIEAs with offshore centres, the Tax Savings Directive, the FATF's report on the 'Misuse of Corporate Vehicles' 2006, amongst other initiatives *supposedly* aimed at stemming money laundering and terrorist financing, did not phase me.

Do you speak BRIC?

The OECD members are not experiencing HNWI high growth. Instead, the BRIC countries of Brazil, Russia, India and China are the clear winners. The BRIC countries, in particular Brazil because of its vast natural commodities base, will continue to lead the world in both economic and HNWI growth. Thus, winning OI firms will provide services which reflect the needs of BRIC clients.

Winning Firms

My forecast for an expanding and robust sector in previous years has not been drawn from the school of thought that "what doesn't kill you makes you stronger", though I often lecture that "the survivors shall inherit the spoils". Rather, I have examined the upward trend in expenditures by firms, and the sector as a whole, that allows them the flexibility to adapt to changing climates and to evolve distinguishing services, such as well rounded, trusted advisors.

By example, for ten years I have measured that growing firms increase investment in education and information, and an increase in these two areas supports that firm's growth. On the other hand, firms' declining revenues, for example through loss of clients and key staff, correlate to a reduction in education and information spending. In the 2008 poll by Robert Half's Accountemps of 1,000 top companies, 94% offered tuition benefits to their key employees.[3] Naturally, this correlation begs the causation question of whether the decline in spending caused decline of revenues, the other way around, or some other factor caused both.

In support of the winners investing in education, this year Cap Gemini reported that "While most HNWIs and UHNWIs have relationships with multiple wealth management firms, many clients seek long-term 'trusted advisors' who can help them navigate complex topics and strategies." The trusted advisor must understand the HNWI "in the context of a larger relationship that encompasses personal and family finances as well as business partnerships or estate planning." As I have written about it many times before, *Offshore Investment* readers will not find the "trusted advisor" concept unique, and neither the family office that has gained so much attention amongst training companies in the last four years as the "new" path forward. This is the way that successful OI firms have always provided service to their clients.

Winner Employees

Also, and more dear to many of the readers, Cap Gemini reported that the employment of qualified talent will sharply increase because of the retirement of the baby boomer wealth manager generation. "Bidding wars among firms for top advisors are not uncommon" and packages will include "bonuses equaling two or three times the payouts from just a few years ago." More directly supporting investment in education, the industry career newsletter, *Jobs in the Money*, reports that credentialed professionals with certifications earn over 30% more than their colleagues.

Loser Firms

In the USA, the Senate Subcommittee report on 'Tax Haven Abuses' (2006), and more recently 'Tax Haven Banks and US Tax Compliance' (2008) have increased the apocalyptic clamouring of those individuals who believe the end of the OI industry is nigh. But these doomsayers have not read their economic indicators. As shown above, the OI industry is healthy, managing a large share of HNWI assets and investments, and earning more fees.

Former UBS private banker Bradley Birkenfeld and Forbes billionaire Igor Olenicoff are certainly losers, as well as LGT and many other named parties in the Senate reports. And if UBS is found to have conspired to commit tax fraud, as opposed to legal tax avoidance, for what it reports as 19,000 US clients with USD17.9 billion "that have not been disclosed to US tax authorities", then the fines and penalties could make the tax shelter witch-hunt of the last four years look innocuous.

What's really going on?

Credible commentators are discussing if the actual purpose of the laundry list of international initiatives is a disguised method to stem the flow of capital from OECD countries to, for example, the BRIC countries and independent financial centres like Dubai and Singapore. Marshall Langer has posited that the OECD's anti-deferral fortress combined with the constant public relations campaigns to demonise international financial centres is really an attempt to re-enact the exchange controls of the pre-Thatcher/Reagan era.

In the 2005 report 'Do Tax Havens Divert Economic Activity?' by professors from Harvard Business School and Michigan's Economics Department, the conclusion is that "the evidence suggests that tax haven activity enhances activity in nearby non-havens" and "it is conceivable that the tax avoidance opportunities presented by tax havens allow other countries to maintain high capital tax rates without suffering dramatic reductions in foreign direct investment". India explicitly understood this rationale when it opened its door to foreign direct investment via its favourable treaty with Mauritius.

How Countries become Losers

Three historical case studies regarding the imposition of withholding tax on interest illustrate the elasticity of foreign direct investment. The case studies are: (1) the 1964 US imposition of withholding tax on interest that immediately led to the creation of the London Euro-dollar bond market; (2) the 1984 US exemption of withholding tax on portfolio interest that immediately led to the capital flight from Latin America of USD300 billion to US banks; and (3) the 1989 German imposition of withholding tax that led to immediate capital flight to Luxembourg and other jurisdictions with banking secrecy, so substantial that the tax was repealed only four months after imposition.

The 1999 IMF report on 'Offshore Banking'[4] concluded that the US experienced immediate and significant capital outflows in 1964 and 1965 resulting from the imposition of a withholding tax on interest. Literature identifies the establishment of London as a global financial centre as a result of the capital flight from the US because of its imposition of Interest Equalisation Tax (IET) in 1964. IET made it unattractive for foreign firms to issue bonds in the US. Syndicated bonds issued outside the US rose from USD135 million in 1963 to USD696 million in 1964. In 1964-65, the imposition of withholding tax in Germany, France, and the Netherlands, created the euromark, eurofranc and euroguilder markets respectively. Conversely, when in 1984 the US enacted an exemption for portfolio interest from withholding tax, Latin America experienced a capital flight of USD300 billion to the US.[5]

In January of 1989, West Germany imposed a 10% withholding tax on savings and investments. In April it was repealed, effective 1 July, because the immediate cost to German banks had already reached DM1.1 billion by that time. The capital flight was so substantial that it caused a decrease in the value of the Deutsche mark, thereby increasing inflation and forcing up interest rates. According to the Financial Times, uncertainty about application of the tax, coupled with the stock crash in 1987, had caused a number of foreign investment houses to slow down or postpone their investment plans in Germany.

A Repeat of 1964?

For the past several years, the US financial services industry has focused on regulatory issues, such as the corporate governance provisions of the Sarbanes-Oxley Act (enacted in 2002) and the banking-related parts of the USA Patriot Act (enacted in 2001). Smaller size companies and community banks have contended that it is too costly for them to comply with certain Sarbanes-Oxley provisions. *Offshore Investment* readers know that this situation has diverted many companies away from the US listing markets to foreign listings, such as the UK's AIM. This past year 39% of global IPO volume, being 1,300 IPOs raising approximately USD300 billion, occurred in the BRIC countries – not using the US capital market as has been past practice.

When Costs Override the Purpose

The provisions of the USA Patriot Act require substantial investments in technology (though many in the industry have questioned the effectiveness of these investments in preventing the funding of terrorist groups or activities).[6] Senior banking management perceives rising and unpredictable compliance costs that undermine global competitiveness as the most significant threats to the future growth of banking.[7]

Based on the survey of Miami banks significantly engaged in international banking, staffing costs rose to 271 full-time employees of anti-terrorism/anti-money laundering compliance for approximately USD25 million in 2005. The average survey respondents indicated that it devoted 2.9 full-time equivalent (FTE) employment positions to BSA/AML compliance in 2002 versus 6.8 FTE positions in 2005. The number of full-time employees devoted to compliance represented 9% of the workforce in 2005. Staff resources devoted to compliance increased by 160% between 2002 and 2005.

The results have been that Miami's banking industry has been characterised by contraction. The number of foreign bank agencies operating in Florida fell from 38 in 2000 to 31 in 2005, of which seven did not book any deposits. There were ten Edge Act banks operating in Florida in 2000, but only seven in 2005. The number of international banking employees (in foreign agencies, Edge Acts and the international divisions of domestic banks chartered in Florida) declined from 4,660 in 2000 to 3,027 in 2005.

The Rest of the World

While the cost of AML compliance increased by approximately 71% in North America between 2004 and 2007, it rose 58% globally.[8] For example, in 2003, the FSA's Anti-Money

Laundering Current Customer Review Cost Benefit Analysis estimated the implementation costs of the AML regime to firms at GBP152 million, substantial by European standards though paltry by American ones.

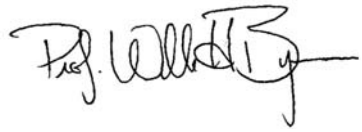
In a 2006 Economist Intelligence Unit survey, international senior bank executives were asked about the costs of compliance of government regulation. When asked what changes they expected in the regulatory environment over the coming three to five years, over 91% stated that they expected regulations affecting their institution to grow in complexity and breadth, 88% stated that compliance with industry regulations will become more onerous, and 81% reported that they expected penalties for non-compliance to increase in severity.

Who wins from all this Compliance?

Besides the army of lawyers advising regulated firms and the chartered accountants undertaking AML and QI audits – the publications market! Because compliance regulations, costs, and penalties are growing more onerous, all regulated financial service providers and their advisors must purchase some information resource to address the variety of compliance issues encountered regularly. Moreover, to undertake the role of the "trusted advisor", a sophisticated wealth manager must have a bundle of reliable resources enabling the holistic, international, business partner approach that modern HNWIs and Ultra-HNWIs now demand.

As a result, the legal, tax and regulatory publishing market is growing consistently. Legal publishing is the largest segment in professional publishing, accounting for approximately 36% of the total market. In 2007, legal publishing revenue was about USD10 billion, up 7.5% from USD9.3 billion in 2006 and 14.9% from USD8.7 billion in 2005.[9] Legal publishers are sparking growth by developing digital tools and software out of their reference book and journal content designed to make it easier for legal professionals to find information and automate mundane tasks. New online publishing will use mind-mapping technology to educate users about holistic connections amongst ideas, issues, and strategies.

And I forecast "As goes the LTR market, so goes the OI sector."



END NOTES:

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