Cayman examines fiscal vulnerability as financial industry rebounds

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While the past year has not been comfortable for the hedge fund industry, it has not brought any significant challenge to the position of the Cayman Islands as the world’s leading offshore hedge fund domicile. In fact, the financial services industry as a whole is healthy, according to the sector’s regulator, the Cayman Islands Monetary Authority. The number of banking and trust businesses and of fiduciary service providers as of September 30 was unchanged from the third quarter of 2008. The number of insurance businesses was in fact up slightly and the number of registered mutual funds fell just 4.4 per cent, from 9,640 to 9,218. In purely statistical terms, the hit to Cayman caused by the recession in European and North American markets has been limited. Neal Lomax, a partner at law firm Mourant du Feu & Jeune, says: “There has been a drop-off in structured finance activity, as there has been elsewhere with fewer banking and finance deals. However, the Cayman Islands remain the jurisdiction of choice for offshore investment funds.” He believes the jurisdiction will have a big part to play in the ongoing process of deleveraging in Western markets. “Given the traditional ability of hedge funds to provide liquidity in the markets, Cayman will have an important role to play in global financial recovery,” Lomax adds. However, challenges lie ahead. The G20 is determined to reinforce global financial regulation, especially for entities such as hedge funds that are perceived – rightly or not – to pose a systemic threat to stability. The G20 is also seeking greater transparency and co-operation on tax issues from offshore jurisdictions. As a result, to its dismay, Cayman found itself in April on the Organization for Economic Co-operation and Development’s so-called ‘grey list’ of jurisdictions that had signed up to international standards of transparency and co-operation in tax matters but had yet to implement them to a satisfactory level. However, the Cayman authorities moved rapidly to put the situation right, signing a number of bilateral agreements in short order. A total of 14 agreements have been signed to date and more are being negotiated. The efforts bore fruit rapidly, with the OECD in August recognising Cayman (soon followed by the British Virgin Islands) as having implemented its tax standard after reaching the threshold of 12 tax information exchange agreements with other jurisdictions, deeming the jurisdictions to have “substantially implemented the internationally agreed tax standard”. Service providers believe that justice has been done. Says Lomax: “Cayman has long understood the importance of effective regulation. As long ago as 2000 it was one of the first non-OECD jurisdictions to adopt the principles of transparency and exchange of information, and there has been a tax information agreement in place with the US since 2001.” In 2005, Cayman agreed to report the savings income of EU-resident investors to their home country tax authorities in line with the EU Savings Tax Directive. However, Cayman must also face up to fresh legal and regulatory changes, notably proposed legislation in the US and Europe that appear designed to make it more attractive for promoters to establish alternative funds in onshore jurisdictions. The European Union’s proposed Directive on Alternative Investment Fund Managers would, in its current form, discriminate against hedge funds domiciled outside Europe and the funds of non-EU based managers. For instance, Andrew Baker, chief executive of the Alternative Investment Management Association, says: “The apparent restriction on funds of hedge funds investing more than 30 per cent in third-country alternative investment funds is concerning.” The problem is not necessarily the letter of the law as it stands now, but the fear of investors that regulation will increasingly become more draconian for offshore jurisdictions and the funds they service. At the margins, regulation may cause a loss of business to Cayman, with onshore structures preferred by nervy investors. To some extent, the solution to this challenge lies within the grasp of Cayman, its government and its service providers. If the territory can improve an image that has been a regular target of onshore politicians and regulators – often unfairly, say many local professionals –it should be able to retain the vast majority of its business. Peter Heaps, managing director of Carne Global’s Cayman office, says: “We need to improve corporate governance by bringing onshore skillsets to the offshore locations. Investors require the same high standards everywhere.” One way of reassuring the investment community is to improve the quality of offshore fund directors, he says, and encourage them to be more proactive. “In the past some directors have been very passive, acting effectively in a nominee capacity,” Heaps says. “They have improved, but they still need to ask more questions about the funds and discharge their responsibilities better. In essence, they need to get the [investment] advisor to comprehend that the fund is not their fund and their money, it is the investors’ capital.” In addition, transparency on Cayman funds, their owners and investors is limited. Says Heaps: “At the moment, it is very difficult to obtain details of any fund in the Cayman Islands; there is no repository of information.” This has historically been seen by detractors as a sign of secretiveness, he argues, and is negative for the jurisdiction’s image. CIMA is currently looking at ways of providing more transparency about the funds it oversees, and is considering a scheme to post certain details on its web site. But Cayman’s service providers are not content to sit back and wait for the authorities to take the lead. Gray Smith, a partner at law firm Appleby, says: “It is important that the industry keeps adapting and that the regulator is industry-friendly. But as much impetus for regulatory change comes from the law firms themselves as from the regulator.” The Cayman government has been quick to move when it sees an opportunity to improve the attractiveness of the jurisdiction to service providers and their clients. This year it has enacted legislation on mergers and consolidation, instituted a new insolvency regime, made changes to the anti-money laundering regime and tabled amendments to the exempted limited partnership law. Close co-operation between industry, government and regulator has been a major feature in the islands’ success to date. Says Lomax: “The Cayman government, the monetary authority and the financial services community will continue to review and enhance the regulatory framework, with a particular and renewed focus on liquidity, risk management, transparency and failure resolution.” This relationship has been tested in recent months by the fiscal difficulties experienced by the islands. In October, the government secured a GBP38m loan to prevent an immediate fiscal crunch caused by a drop in revenues across the financial services industry, which underpins much of the local economy, including the close of some funds and the decline in assets under management across the industry. The UK government, which runs the external affairs of the British overseas territory, told the Cayman government it should implement fiscal reforms urgently, including perhaps the introduction of a corporate income tax. This represented a dramatic swing from the fiscal position of most of this decade, when the islands’ budget was in good health as thousands of hedge funds were launched and other financial services business flocked to its shores. The government was confident enough about the sustainability of its revenue base to launch a sizeable public investment programme. But the bill for that expenditure is now coming due, just as tax revenues are suffering with the decline in tourism and financial sector activity. Although funds do not pay direct taxes, the industry has contributed strongly to other economic activity that brings sizeable tax revenues. Car import duties, for example, have been an important source of revenues. On June 30, the country was nursing a cash deficit of KYD81.1m (GBP63m), while the proportion of net debt to revenue was 86 per cent, exceeding a UK-imposed cap of 80 per cent. In late August, the government stopped paying its suppliers, and a war of words with London ensued after the UK government refused to guarantee a larger loan to clear Cayman’s budget shortfall. The situation is, to a large extent, resolving itself as hedge funds and other financial sector businesses rebound, but some observers say the islands need to diversify the tax base to avoid similar situations in the future. The last thing it wants is to have to levy new taxes on business and reduce its competitiveness. Peter Hughes, managing director of administration firm Apex Fund Services, says: “Cayman had to be bailed out by the UK government basically because of its focus on hedge fund servicing. If this starts to shift onshore, there will be a major threat to the islands.” He argues that while other offshore locations have fiscal problems too, they may have broader bases. “In Bermuda, fund servicing is a smaller part of what they do,” says Hughes. “Banking and insurance are significant sectors there too.” That said, Cayman also has a significant banking sector, and in recent years it has carved out a useful niche in captive insurance vehicles for smaller businesses. Smith says a general examination of the jurisdiction’s finances every now and again is no bad thing. “We are having healthy discussions now,” he says. “Before, the way the government managed its finances was never really talked about, so this can be seen as a positive development.” Complacency seems the one factor that could derail the Cayman juggernaut. It commands such a position in the hedge fund industry that only wilful neglect could alter it. As Smith says: “The barriers to entry are too high for other offshore centres to take a significant share. There is no real reason for investors to go anywhere else – most say, ‘If the system ain’t broke, there’s no need to fix it’.” Click here to read the Cayman Hedge Fund Services 2009 Special Report [1]

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